# EXAMINING THE SEC'S MONEY MARKET FUND RULE PROPOSAL

## HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

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U.S. HOUSE OF REPRESENTATIVES

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# EXAMINING THE SEC'S MONEY MARKET FUND RULE PROPOSAL

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**Wednesday, September 18, 2013**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Neugebauer, Westmoreland, Huizenga, Grimm, Stivers, Mulvaney, Hultgren, Ross, Wagner; Maloney, Sherman, Lynch, Moore, Perlmutter, Scott, Himes, Peters, Ellison, Watt, Foster, Carney, and Kildee.

Ex officio present: Representative Hensarling.

Chairman GARRETT. Greetings and good morning. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order.

Today's hearing is entitled, "Examining the SEC's Money Market Fund Rule Proposal," and I thank all the members of the panel for being with us today. We will be looking to you for your comments in a moment.

I also thank the members of our committee who are here to examine this important issue.

We will now have opening statements, and I will begin by yielding myself 6 minutes.

Following the events of the financial crisis, in which some of the money market funds, as you know, experienced heavy investor redemptions, the SEC had proposed a rule for which the stated intent was making money funds less susceptible to future runs and improving the transparency of money market fund risk.

The process leading to the SEC's current rule proposal reflects the good, the bad, and the ugly of agency rulemaking. In fact, it is really a tale of two different rules.

The first iteration of that would become a current rule proposal considered by the SEC more than a year ago, as a cautionary example of agency rulemaking gone wrong, both in terms of process and substance.

As SEC Commissioner Dan Gallagher described it, the original proposal was presented to the Commission by the then-SEC Chairman as, "inviolate fait accompli, having already been fully-baked and blessed by other agencies without the input of the Commissioners and lacking in adequate economic analysis."

But thanks to the efforts of Chairman Issa and his staff on the House Oversight and Government Reform Committee, we are now able to construct a picture of what appears to have been a wildly, closely coordinated effort by the SEC Chairman and FSOC and the Federal Reserve to develop the substance of the original rule proposal and to exert undue political influence on the Commission to accept it.

To highlight just one example, documents obtained by Chairman Issa's committee appeared to show certain individuals of the SEC working together with the Fed to draft a letter for FSOC back to the SEC, pressuring the Commission to adopt specific money fund reform measures, and then dangling the possibility that FSOC would take those matters into its own hands.

This collaboration appears to have occurred well before the Commission was even set to vote on the original rule proposal. Then, after the original rule proposal ultimately failed to gain the support of the majority of the SEC Commissioners necessary to bring the matter to a vote, what happened?

The FSOC doubled down, again pressuring the SEC to act on specific money market fund reforms by issuing and seeking comment on its own reform recommendations. So, given the significant intrusion of banking and systemic risk regulators in the SEC process, it should come, then, as no surprise that the focal point of the original rule proposal was a requirement that money market funds implement what is commonly called capital cushion, or buffer.

So while this capital buffer requirement was reportedly designed to make money market funds better able to withstand heavy redemptions during times of market stress, I believe that it was, and it continues to be, an entirely inappropriate option for money market funds.

First, money market funds are fundamentally a securities product. And I believe the consumer should think of them as such. Forcing money market funds to hold bank-like capital will only foster the false perception and impression among many investors that these funds are more like federally-insured bank accounts and security products.

Second, as the SEC itself has since concluded, the capital buffer contemplated in the original rule proposal would likely be insufficient to absorb very large losses on the level experience during the financial crisis. But a buffer high enough to do so would be too costly to be practical.

And third, as Commissioner Gallagher has pointed out, the only real purpose for the proposed buffer was to serve as the price of entry into a emergency lending facility at the Federal Reserve that they could construct during any future crisis.

In short, the buffer would provide additional collateral to provide a Fed bailout to the troubled funds.

With the Obama Administration's precedent-setting bailouts of the auto industry and Fannie Mae and Freddie Mac, costing literally billions of dollars, we simply cannot afford to extend yet another taxpayer-funded bailout, and the moral hazard that goes with it, to money market funds.

When rulemaking is done correctly, it is a deliberative and thoughtful process based off of hard economic pattern. Fortunately,

the second iteration of the SEC's money fund proposal, the rule proposal that we are going to be taking a look at today, seems to be more in line with that standard.

The current rule proposal sets forth three alternatives, in addition to certain enhanced dislosure requirements, and I will run through them.

First, it has a floating net asset value (NAV) requirement for specific types of money market funds called prime institutional funds. Second, it has mandatory liquidity fees and discretionary temporary redemption gates for all nongovernment money market funds during the times of market stress. And third would be a combination of these two alternatives.

So, unlike the original proposal, the current proposal was informed by the results of a study of money market funds conducted by the SEC's division of economic and risk analysis, which show the heaviest redemptions during the financial crisis were where? In the prime institutional funds.

Moreover, I was pleased to see that the current rule proposal does not include a capital buffer or alternative that enshrined taxpayer bailouts and makes security products look more like bank products.

I believe that the decision to exclude a capital buffer from the SEC's current rule proposal is very much an important step in resisting the push to remove substantially all of the risk from security products.

It is what ultimately hurt investors by reducing their ability to generate much-needed returns on their investment and their retirement dollars.

And so, while I may not necessarily agree with every single aspect of the SEC's current proposals, and I am sure we will hear from the panel today, and recognize that many of the important questions remain outstanding, I appreciate the SEC's commitment to engage in a thoughtful and deliberate process this second time around.

Ultimately, I believe it is critically important that we strike the right balance between ensuring that money market funds can survive during periods of market stress, and preserving their role as an important investment and cash management tool for all types of investors. To that end, I do look forward to a robust debate this morning on the positive, and the negative, of the SEC's proposals.

And with that, I yield to the gentlelady from New York, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. I thank the chairman for holding this important and timely hearing, and for doing so in such a bipartisan way. Nearly 50 million investors use money market funds, which collectively hold about $2.9 trillion in assets. This is a huge market, which is why this issue is too important to get bogged down in the usual partisan politics.

The SEC has put forward a thoughtful proposal to reform money market funds, and it deserves a serious discussion. To encourage this, the chairman and I have tried to ensure that a broad range of views are represented on the panel today, and I very much look forward to your testimony and to the debate that follows.

Before we get into the SEC's proposed reforms, it is important to remind ourselves why reform is needed. On September 16, 2008, the Reserve Primary Fund, a $62 billion money market fund that had invested in Lehman securities, broke the buck, meaning the value of its shares fell below $1.

This was only the second time a U.S. money market fund had ever broken the buck in U.S. history. This event sparked a massive, and I would say terrifying, run on the money market fund. Never has my phone rung so much off the hook in the middle of the night, during the day, "run on the funds, are we going towards a depression, what is happening," but by the end of the week, investors had withdrawn over $300 billion from the prime fund, and on September 19th, just 3 days later, really 2 days later because they didn't announce they broke the buck until the end of the first day, the Treasury Department and the Federal Reserved bailed out the entire money market industry by effectively guaranteeing over $3 trillion of money market shares.

I think it is safe to say that obviously, we do not want this to happen again, and we look forward to working together to prevent it. To its credit, the SEC in 2010 adopted some very substantial money market reforms which include the quality of the securities that money market funds can hold, and established minimum liquidity requirements for money funds.

However, as the SEC noted at the time, the 2010 reforms did not address the fact that money market funds are still susceptible to devastating investor runs that can destabilize the entire financial system.

The question before us today is what reforms are needed to prevent future runs on money market funds. In June, the SEC, under the leadership of Chair Mary Jo White, issued a proposed rule that is intended to answer this question. The Commission proposed two alternatives, both of which take into account the considerable progress the SEC made with the 2010 reforms, and they are both narrowly focused on the problems that emerged in 2008.

While most of the attention is focused on the SEC's floating NAV proposal, I am interested in the witnesses' thoughts on the so-called "gates and fees" proposal. Are liquidity fees a strong enough deterrent to prevent runs, and would the prospect of going 30 days without access to your money prompt investors to withdraw their funds at the first sign of any trouble? These are two questions I would like answered in your testimony today, and I look forward to exploring other questions during the hearing.

Thank you for being here, and I yield back.

Chairman GARRETT. The gentlelady yields back. The gentleman from Virginia, Mr. Hurt, is recognized for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman. I want to thank you for holding today's subcommittee hearing to examine the SEC's proposed rules for money market mutual funds. I know our panel will provide their views on the SEC's current proposal, but my concerns also extend to the process by which we came to this proposed rule.

After former SEC Chair Schapiro was unable to pass a money market fund proposal through the SEC, the FSOC inserted itself into the rulemaking process by proposing its own guidelines pursuant to its authority under the Dodd-Frank Act.

This action by the FSOC raises concern for the development of financial regulation in the future and carries significant consequences for government and industry. Congress entrusts financial regulatory responsibility to specific regulatory bodies with specific areas of expertise and jurisdiction. Here, the SEC has overseen the regulation of money market funds for decades, and it understands the product best. Presumably, Congress did not establish FSOC's authority under Section 120 as a means for a new regulatory body to undermine the decisions of the specialized, independent regulatory agency.

Additionally, as a Commission dominated by political appointees, FSOC, armed with this authority, has the ability to pressure regulators whose actions do not align with the current Administration's views. FSOC remains outside of the congressional appropriations process, further allowing for this potential politicizing of financial regulation outside of appropriate congressional accountability.

Finally, FSOC is proposing its money market fund rules did not establish guidelines for future uses of their enhanced authority, thereby leaving the door open to the possibility of numerous encroachments in the regulatory purview of other financial regulatory agencies.

Ultimately, independent agencies with five members must be allowed to work their will. The FSOC's authority leaves the offending regulatory body, in this case the SEC, with the choice of yielding or being forced to implement a final rulemaking designated by FSOC on any topic, let alone money market funds.

Either option lessens the effectiveness of regulatory agencies that are directly accountable to Congress, and ultimately, to the American people. I want to thank our witnesses for being here today. I look forward to their testimony, and I thank you, Mr. Chairman.

I yield back my time.

Chairman GARRETT. Mr. Lynch?

Mr. LYNCH. Thank you, Mr. Chairman. And I thank the ranking member, as well.

I would also like to thank the witnesses for their willingness to come before the committee and help us with our work. Today, we are looking at a proposed rule by the Securities and Exchange Commission to impose a floating net asset value on prime institutional money market funds, create liquidity fees and redemption gates when a fund falls well below the healthy liquidity levels, or some combination of these two things. But before we talk about the rule itself, I think it is important to remember why the reforms are so necessary.

First and foremost, money market funds are an important cash management and investment tool for a variety of investors, and they serve an important role in the overall financial landscape as an alternative to big banks. However, as the ranking member pointed out, in September of 2008 when the Reserve Primary Fund broke the buck, we all realized that there were fundamental structural flaws in the industry that made it susceptible to runs.

To stop that run, which could have sent the economy off the cliff, the Federal Government stepped in and guaranteed investments in those funds, exposing taxpayers in an unexpected and troubling way. So, we need to find a better way to prevent the kind of panic

that caused a run on the money market funds back then, but also that preserves the important role that they play.

The SEC issued a rule in 2010 which made money market funds more stable and transparent by improving the liquidity and credit quality of the securities that those funds hold, and this was a good first step, but I support the SEC's efforts to continue to address the weakness in the money market funds exposed by the financial crisis.

The SEC rule we are examining today is narrowly targeted at the weakness exposed by the crisis, while trying to preserve the retail funds and government funds which perform relatively well under that stress. I think that is probably the right approach, however I am concerned that some of the definitions the SEC uses to separate prime institutional funds from retail funds and government funds may have a negative effect on local governments that rely on those money market funds.

I hope the witnesses here today will help the committee understand the effect that this rule will have on municipal government financial ability because this area of money market funds played an important public role that we may want to preserve. Thank you, Mr. Chairman, I yield back.

Chairman GARRETT. Mr. Hultgren for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here.

Having served in local and State government before my time in Congress, I do want to recognize the direct and immediate impact the SEC's reform could have on municipal finance, as my colleague has mentioned as well. Money market funds provide a unique and widely-used municipal cash management product that may no longer be available as the DNA of money market funds has changed.

I am also concerned that the SEC's inclusion of tax-exempt municipal money market funds will drive away money market investors, dampening these funds' interest in municipal securities. Currently, over 50 percent of outstanding short-term municipal debt is held by money market funds. If this demand dries up, municipalities will see higher issuance costs.

Finally, I share some concerns highlighted in testimony relating to the SEC's effective subsidy of Federal Government debt. Excluding Treasury and GSE debt from the proposed reforms isn't bad, but giving these products special treatment only enables the Federal Government's fiscal irresponsibility at the expense of States and localities.

I welcome the witnesses' testimonies, and I thank the chairman for holding this hearing. I yield back.

Chairman GARRETT. The gentleman yields back the time.

Mr. Perlmutter, the gentleman from Colorado, for 2 minutes.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

And to the witnesses, thank you for being here.

My first comment is in response to the chairman and to Mr. Hurt. The oversight council is doing what it is supposed to do, which is to oversee a financial system and to look for places where there may be problems and bumps and humps and all of that sort of stuff.

And so to the process, I disagree with the gentlemen in terms of their opening. I also would say, just as a matter of record, any assistance to Fannie Mae and Freddie Mac came at the end of the Bush Administration, so it wasn't an Obama bailout.

Now, to get to the substance of the rules, I would like testimony today about the floating net asset value proposal, because I think we actually floated that. It was floated 3 years ago.

And from my perspective, having watched the reserve fund break the buck, then pursue bankruptcy, which the SEC then had to oversee, folks didn't get a dollar back. They got something less than a dollar. And because of the securities-type nature of the investment, I think they got what they deserved.

And so I know the effort here is to mark everything each day, and if something is worth 95 cents that individuals know that, but they know going in that they are buying a security. Disclosure was part of the rule as it was written 2 or 3 years ago. So I don't know that having a floating net asset value changes the picture very much.

And even though I approve and I applaud the process where the oversight council was participating in this rulemaking, I think that is appropriate, I would just say that I am not sure that this answer is—and this rule is going to make any difference.

Chairman GARRETT. And finally, for the last word, I believe, Mr. Scott.

Mr. SCOTT. Thank you, Chairman Garrett. First of all, let me welcome Mr. Steven McCoy, who is the treasurer of the great State of Georgia. It is good to have you here. Say hello to the folks back home.

First of all, I do want—I think Mr. Perlmutter really put his finger on it in terms of the floating net asset value. And what we are talking about here is a net asset value per share instead of a value of $1 per share price.

Now while proponents of a floating net asset value claim, as I understand it, that it would make markets more flexible and allow funds and markets to remain open and functioning during a crisis—that is basically that argument, and I appreciate that.

But we must also at the same time be sure to address concerns that such a reform would eliminate prime money market funds, and State and local governments in turn would lose a valuable tool in money management and would drive up the cost of financing short-term borrowing. That to me seems to be the crux of where we are.

What I think what we need to reach for here is a delicate balance where we can accommodate both. I just simply want to be able to keep regulations in place that are strong, that are effective, that protect our consumers, while at the same time being able to quickly respond to the ever-changing economic climate and justify a policy accordingly where needed.

And so, I think that is our challenge today. I think we need a delicate balance. I yield back.

Chairman GARRETT. The gentleman yields back. And before we go to—the gentleman from Georgia just entered. While he sits down, I just wanted to, without objection, enter into the record a letter from the Financial Services Roundtable on this topic, and

also a letter from the Mutual Fund Directors Forum. Without objection, it is so ordered.

If the gentleman from Georgia is prepared, we have I believe another minute for the gentleman.

Mr. WESTMORELAND. Thank you, Mr. Chairman. And I want to take a moment to welcome Mr. Steven McCoy, the treasurer of my home State of Georgia. It is always good to see a Georgian represented on the panel. I look forward to your testimony on how the SEC rules impact the way Georgians invest their hard-earned money as taxpayers.

The subject matter of this hearing might be technical, but for me the bottom line is we need a broad array of financial products for investors of all shapes and sizes to choose. With the Federal Reserve depressing interest rates for savers, many retail and institutional investors choose money market funds because they provide a better return on investment.

Congress, the SEC, FSOC, and yes, even the bank regulators, must pursue regulations and policies that create diverse, liquid financial markets. I urge careful consideration of all the unintended consequences of this rule. I yield back.

Chairman GARRETT. The gentleman yields back, and I thank the gentleman.

So now, we turn to the panel. There is a gentleman who has been recognized twice now for your work in Georgia, the treasurer from the State of Georgia, Mr. McCoy, you are recognized. I know most of you have been here before, but I always restate this.

You are recognized. You will be recognized for 5 minutes, and we ask you to make sure that when you speak, you pull your microphone as close as you can, so that we can hear you. Make sure the light is on. And of course, as you all know, you have 5 minutes. The yellow light gives you a one-minute warning, and the red light means you are out of time.

So Mr. McCoy, you are now recognized for 1 minute.

**STATEMENT OF THE HONORABLE STEVEN N. McCOY, TREASURER, STATE OF GEORGIA, ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS (NAST)**

Mr. MCCOY. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. On behalf of NAST, I thank you for providing us the opportunity to testify on the SEC's proposed money market fund reforms.

NAST is a bipartisan association. It is comprised of all State treasurers and State financial officials throughout the country. Treasurers, given their role within each State of ensuring proper cash management, do have a unique perspective on money market fund regulation, and we appreciate being able to share our perspective on this.

Money market funds are an important investment tool for many State and local governments throughout the country. They rely on money market funds as short-term investments that provide liquidity, preservation of capital, and diversification of credit risk.

But then also, as we have heard in the Congressmens' statements, they are very important to State and local governments since we are issuers of short-term debt. And the short-term debt—

the municipal money market funds are the largest purchasers of short-term debt. And any reform that would limit the attractiveness of money market funds to purchase municipal bonds would—and reducing the demand would increase our financing costs.

But additionally, and the place I would like to spend the most of my time today, since I think the other panelists are going to deal with the purchasing of money market funds, the two primary issues of floating NAV and liquidity in gating, and also with municipal money market funds.

But one of the things that I would like to focus on is local government investment pools. Most States have created them over the years. They go back over 30 years with a history of pools. And they are a safe and efficient method of investing State and local government funds.

Changes to the regulation of money funds, even though local government investment pools (LGIPs) are not registered with the SEC, that still these reforms could indirectly impact our operation and viability because GASB has two regs, 31 and 59, which require externally-managed pools to be 2a-7 light in order to use amortized cost accounting and preserve a stable NAV.

So what I would like to do is just focus on the potential impact on LGIPs of the proposed regs. LGIPs operate for the exclusive benefit of governmental entities within each State. They are distinguished from money market funds in that they are not open to the public.

Instead, LGIPs serve only governmental entities that otherwise would have difficulty investing public funds safely and efficiently. This is both large and small government entities that, while these State statutes governing LGIPs differ, LGIPs generally accept deposits from cities, counties, colleges, school districts, authorities, public hospitals, and various commissions and boards.

In some cases, like Georgia, we also commingle the State's short-term assets in our local government investment pool to create economies of scale so the local governments can benefit from the economies of scale that we use, and they can also benefit from our credit research and our experienced investment officers.

LGIPs are often used by participants to invest funds that are needed on a day-to-day basis or on a near-term basis. And so even though they are exempt from SEC regulation under the Investment Company Act of 1940 because of sovereign ownership, the SEC's proposed changes could have some unintended consequences that would indirectly impact our ability to continue to offer these safely and efficiently.

For instance, converting an LGIP to a floating NAV or imposing liquidity fees and gatings, both would be in violation of many of the States' statutes, and also prudent investment policies. As government entities, we cannot tolerate loss of principal on operating funds, trust funds or bond proceeds because we have no method of replenishing losses.

So we have to be very careful to preserve capital and have liquidity. We need it to make—so liquidity constraints, preservation of capital and preservation of liquidity is very important to us. That we cannot accept liquidity constraints that could prevent us from

funding or local governments from funding critical public needs, of paying debt or other obligations when due.

Local government investment pools hold money, provide an attractive yield, and provide liquidity so that all participants know their money is there and available and safe. Some may point to bank deposits as an alternative, but States typically require collateral on bank deposits. And so those—they have to be collateralized sometimes, in our State for instance, at 110 percent with marketable securities.

So the cost associated with collateralizing public bank deposits limits many banks from providing competitively-priced alternatives. Also, the availability of eligible collateral will limit the amount of bank deposits, collateralized deposits that banks, especially in smaller communities, would accept.

In wrapping up, I would like to say that we appreciate the opportunity. We have asked that the SEC include a comment just that they do not intend this to be applicable to LGIPs. Thank you, sir.

[The prepared statement of Mr. McCoy can be found on page 84 of the appendix.]

Chairman GARRETT. Thank you. And now, we welcome back Ms. Sheila Bair, the former Chair of the FDIC, who is now Chair of the Pew Charitable Trusts, Systemic Risk Council. Welcome once again to the panel. And you are recognized for 5 minutes.

**STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIR, SYSTEMIC RISK COUNCIL, AND FORMER CHAIR, FDIC**

Ms. BAIR. Thank you, Chairman Garrett, and Ranking Member Maloney. As a number of Members have noted, 5 years ago this week, the Reserve Primary Fund, a massive money market fund that held just 1.3 percent of its assets in Lehman Brothers debt, announced it would break the buck, and the financial markets froze.

In just 2 days, the $62 billion fund received requests from investors to return approximately $40 billion of their money. The money fund quickly depleted cash reserves and tried to sell assets. This not only further depressed the value of its holdings, but depressed the value of other money market mutual funds as well.

Because the Reserve did not have capital or a deep-pocketed parent who could subsidize its losses, the fund had to reprice its shares going from $1 to 97 cents. Reserve investors waited months for full access to the remaining cash and, based on recent press reports, the dispute between the SEC and the Reserve is still ongoing.

The run on Reserve, however, quickly spread to other money market funds. During this week, 5 years ago, investors withdrew $310 billion from prime money market funds.

To meet these requests, other money funds, just like the Reserve, began to sell more securities into illiquid markets, further reducing their values and putting other money funds, stable $1 NAV, at risk.

Many sponsors subsidize their funds to defend the $1 NAV. Further fearing redemptions, many funds limited new investments to cash, Treasuries, and overnight loans.

U.S. corporations and municipalities seeking to access the short-term markets for cash were out of luck. Short-term interests rates spiked and credit markets froze.

On September 19th, the government stepped in with massive and unprecedented taxpayer support. The Federal Reserve created a special liquidity facility to aid money market funds and the Treasury Department used the Exchange Stabilization Fund (ESF) to guarantee trillions of dollars in shareholders' money fund holdings.

Almost every money fund opted to this after-the-fact insurance policy created almost overnight by the Federal Government. While the bailout worked to calm the short-term markets in 2008, Congress prohibited the Treasury Department from again using the ESF to guarantee money funds.

And while some modest reforms were put in place in 2010, the core structure risk and money funds that nearly brought the financial system down in 2008 still remain and threaten our financial system today.

The core structural risk is a special SEC rule that allows money funds to price their shares at one dollar even when the value of their underlying assets is not worth a dollar.

This special treatment called the stable NAV is what makes money funds different from other mutual funds and so susceptible to destabilizing runs. It effectively pays first-movers to run and imbeds losses on remaining shareholders.

Even if shareholders don't want to run, they do not want to risk paying for someone else's losses.

While the SEC recently proposed some modest changes to the structure of money market funds, the proposed reform options have too many holes and exceptions to adequately protect the financial system.

One proposed option, the limited floating NAV option, would leave the structural risk in money funds that cater to retail investors or invest large portions of their assets in agency securities, including Treasuries, the Federal Home Loan Banks, Fannie Mae, and Freddie Mac.

As we know, these assets are not free from risk, but the SEC proposal is treating them as if they are.

Moreover, this special treatment for money funds that make investments in those firms over firms that make investments in other U.S. companies effectively further subsidizes Treasuries, the Federal Home Loan Banks, Fannie Mae, and Freddie Mac, over private market competitors.

That is a mistake at a time when the government should be working to reduce government subsidies which distort capital allocation. This goes in the opposite direction.

The other "gates and fees" approach is actually worse than current law because it will encourage investors to run sooner in order to avoid the "gates and fees."

A better approach is to treat all money funds like other mutual funds and require a simple, floating NAV. As seen during the 2008 crisis, the rigidity and destabilizing effects of a stable NAV can shut down markets and make crises even worse.

A floating NAV is much more flexible and allows funds and markets to remain open and functioning in a crisis. Moreover, while other crises may occur, they would no longer be caused or exacerbated by the stable NAV.

Finally, a strong floating NAV approach, as outlined in my written testimony, would help level the playing field for investment companies and investors by helping ensure that investment decisions and competitive outcomes are based on the quality of asset allocation decisions not the moral hazard of potential sponsor support.

This is the same, simple, regulatory framework that applies to all other mutual funds, a framework that the SEC has implemented successfully and without systemic risk or taxpayer bailouts since 1940. Thank you very much.

[The prepared statement of Ms. Bair can be found on page 52 of the appendix.]

Chairman GARRETT. Thank you.

And next, we will hear from Ms. Chandoha, the president and CEO of Charles Schwab Investment Management, Inc. You are recognized for 5 minutes.

**STATEMENT OF MARIE CHANDOHA, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CHARLES SCHWAB INVESTMENT MANAGEMENT, INC.**

Ms. CHANDOHA. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, my name is Marie Chandoha. I am president and chief executive officer of Charles Schwab Investment Management, Inc., the asset management business of the Charles Schwab Corporation.

Thank you very much for the opportunity to discuss Schwab's perspective on the SEC's money market fund proposal. Schwab is one of the largest managers of money market funds, with 3 million accounts and nearly $170 billion of assets.

The vast majority of these assets are held by individual investors. Approximately 88 percent are held in sweep funds which automatically invest cash balances while providing investors with convenience and liquidity.

These sweep accounts allow retail investors to easily buy and sell stocks, bonds, and mutual funds and also allow them to write checks and pay bills electronically.

Even in the current environment of historically low yields, individuals continue to use money market funds as a central element of their financial lives.

We generally support the SEC's reform proposal. It is a serious and substantial proposal that strikes the right balance between reducing the likelihood of runs while also preserving money market funds as an extremely important cash management vehicle for individual investors.

We further support combining the two alternatives that the SEC has proposed requiring institutional money market funds to move to a floating net asset value and allowing, but not mandating, a fund's board to impose redemption gates or liquidity fees if necessary during times of stress.

We believe that redemption gates and fees could be a useful mechanism for an orderly liquidation of a fund that is in trouble.

We agree with the SEC that the rule should focus on the greatest areas of risk by proposing a clear distinction between institutional and retail investors. Retail money fund investors have shown no propensity to run. Even in the financial crisis of 2008, retail investors did not run. Runs have been triggered by institutional investors who have large amounts of cash in the funds and who have the resources and technology to redeem very quickly.

Targeting the area of greatest risk is the goal of any sensible regulation and we believe that the SEC has achieved that with their proposal. However, we do think that the proposed rule has a number of areas that can be modified in order to maintain the viability of this crucial investment product for the individual investor.

Let me make two brief points. First, municipal money market funds should continue to have a stable NAV. These funds are much more liquid than prime funds and therefore much more resistant to runs.

Both the SEC's analysis and our own experience shows these funds have been resilient in times of stress. Even in the midst of the 2008 financial crisis, municipal funds did not experience the redemption levels of prime funds.

Second, the tax problems related to a floating NAV must be resolved before implementation so that investors are not forced to track and report hundreds of capital gains and losses. That would be an administrative nightmare for taxpayers.

While we support the proposal, the rule is likely to result in significant outflows from prime money market funds. On one hand, this will reduce the size of the industry which ultimately reduces the systemic risk, but it is not clear where the outflows would go as investors still need to invest their cash.

Some would undoubtedly flow to government and Treasury money market funds, but there is some question as to whether there would be enough of these type of securities to absorb the inflows.

We also want to observe that the cost of implementation and the potential impact of the reforms on the financial system are both significant. We urge the SEC to carefully analyze whether these costs are outweighed by the benefits.

In our comment letter, we list some recommended changes that would ameliorate some of these costs while still achieving the policy goals of this reform. Even with these changes, the costs remain significant.

In closing, let me be clear. The SEC has proposed a serious set of reforms that will have enormous ramifications for the money fund industry. They will be costly for Schwab and other firms to implement, and they represent a fundamental overhaul of a product investors of all types have relied on for more than 4 decades.

But we do support the proposed reforms because they are targeted at the most serious risks. Other regulators have called for a one-size-fits-all approach that would destroy the product for individual investors. We believe the SEC has found a tough yet pragmatic solution that will boost investor confidence, deter destabilizing runs, and ensure that individual investors can continue to

rely on this critically important product. Thank you very much for inviting me to testify, and I look forward to answering your questions.

[The prepared statement of Ms. Chandoha can be found on page 59 of the appendix.]

Chairman GARRETT. Thank you.

Next up, for 5 minutes, we will hear from Mr. Gilligan, who is representing the U.S. Chamber of Commerce.

**STATEMENT OF JAMES P. GILLIGAN, ASSISTANT TREASURER, GREAT PLAINS ENERGY, INC., ON BEHALF OF THE U.S. CHAMBER OF COMMERCE**

Mr. GILLIGAN. Good morning, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I thank you for the opportunity to discuss the potential impact of the SEC proposal on money market funds on the business community.

My name is James Gilligan, and I am the assistant treasurer of Great Plains Energy Incorporated, which is the holding company of Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company based in Kansas City, Missouri. Our electric utilities serve over 830,000 homes and businesses in 47 counties in Missouri and Kansas.

I also serve as the chairman of the Association for Financial Professionals Government Relations Committee, and I am here today testifying on behalf of the U.S. Chamber of Commerce and the thousands of corporate financial professionals who are tasked with managing their companies' cash flows and ensuring that they have the working capital and liquidity necessary to efficiently support their operations.

There are several important points I wish to stress to the subcommittee today. Money market funds have existed for over 4 decades. These funds are used by businesses throughout the United States to meet their cash management and short-term funding needs.

They are an integral part of a tightly interwoven system for low-cost, short-term business financing of unrivaled liquidity and efficiency. This system has served the American economy well, and provides a competitive advantage for American businesses in global markets.

The Chamber and the corporate treasury community believe that the major rule changes to money market mutual fund regulations that were implemented in January 2010 were well-conceived and strengthened the product to withstand significant market stress.

As the SEC considers moving forward with additional regulation, it is incumbent on the Commission to take a balanced and data-driven approach to further strengthen money market funds while preserving the critical role they serve for U.S. businesses and non-profit organizations. If the floating NAV proposal is adopted for institutional prime money market funds, it would fundamentally alter the product, eliminating stability and liquidity, the key attributes that attract investors.

Thus, money market funds would no longer remain a viable investment option to many treasurers and financial professionals. Consequently, with fewer investors and less capital to invest,

money market funds would no longer remain a significant purchaser of corporate commercial paper. The reduced demand would drive up borrowing costs significantly by forcing companies to fund their day-to-day operations with less efficient and more costly alternatives.

Currently, Great Plains Energy offers interest rates to investors on our commercial paper in the current range of 30 to 70 basis points.

If, instead, we had to use our revolving credit facilities with our banks for overnight borrowings, those borrowings would be priced at the prime rate, plus a spread, which at current rates, is at least 3.3 percent, or 330 basis points—10 times higher than where we can place overnight commercial paper.

In addition, the company would be required to borrow at least $1 million, whereas commercial paper can be sold in increments of $100,000; and to request a more comparable LIBOR-based borrowing from our bank group would require 3 days prior notice, have a minimum term of 30 days, and be for a minimum amount of $5 million, and it would still be at a rate of about 125 basis points higher than our commercial paper for the same term.

This is a cheaper option, but again, it is up to 4 times more expensive than commercial paper.

The SEC's proposal acknowledges that a floating NAV will not necessarily reduce the risk of widespread redemptions during times of market stress, and given the uncertainty as to whether this proposal will protect against a run on money market funds, we believe it is inappropriate to implement the proposal since it will undermine the value and key attributes of money market funds while driving up costs drastically.

The Chamber does support greater transparency with respect to the holdings of money market funds and the daily disclosure of a shadow NAV that many funds currently report—provide investors with the benefits of a floating NAV without jeopardizing the viability and utility of money market funds.

In conclusion, the cost of the floating NAV far outweighs the benefits and is another case of where the medicine may kill the patient. This concludes my statement and I am happy to answer any questions. Thank you.

[The prepared statement of Mr. Gilligan can be found on page 72 of the appendix.]

Chairman GARRETT. Thank you.

And finally, from the Investment Company Institute, Mr. Stevens is recognized for 5 minutes.

**STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE INVESTMENT COMPANY INSTITUTE (ICI)**

Mr. STEVENS. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. It is a pleasure to be with you this morning.

The SEC rulemaking that you are examining really is vitally important to some 61 million individual investors, and literally thousands of institutions in our country, including businesses, State and local governments, and nonprofits that depend, today, on

money market funds as a low-cost, efficient cash management tool, and one that provides a high degree of liquidity, stability of principal value, and a market-based yield.

For 5 years, ICI and its members have worked diligently with the SEC, with the Congress, and with other regulators to develop ideas about how to make money market funds more resilient under even the most adverse market conditions.

I would observe that the SEC has 40 years of success in regulating these funds. Its expertise and its experience mean, in our judgment, that the Commission is in the best position to implement any further reforms.

In our work on money market funds, we stress two principles consistently. First, the reforms should preserve the fundamental characteristics that make money market funds so valuable to investors and to the economy, as you have heard on the panel this morning.

And second, that we should preserve choice for investors by insuring a continued robust and competitive money market fund industry.

Now, applying those two rules to the SEC's rulemaking, those two principles, I would offer 5 summary conclusions. By the way, I would note for the subcommittee's benefit, we did file yesterday about an 80-page comment letter on these, so this is, in fact, just the top line.

First, we agree with the Commission that there really is no reason to apply structural changes to funds that invest primarily in Treasury or other government securities—collectively, government money market funds.

Second, funds that invest primarily in short-term debt of State and local governments should be exempted from these structural changes. The characteristics that the SEC attributes to government funds apply with equal force to those of tax-exempt municipal funds.

There is no evidence that investors in tax-exempt money market funds redeem en masse during periods of market stress. Moreover, these funds hold the great majority of their assets in highly liquid securities that can be liquidated to make redemptions.

Experience also shows that credit deterioration in securities issued by one jurisdiction does not tend to affect other jurisdiction's securities. Given the vital role that they play in financing State and local governments, tax-exempt funds should not be subjected to disruptive and expensive structural changes.

Third, in discussions with our members and their shareholders, one thing has become crystal clear—combining the SEC's two proposals would render money market funds entirely unattractive to investors.

The Commission's proposals, in effect, confront investors with a choice: sacrifice stability, in the case of floating net asset values on prime institutional funds; or face the prospect of losing liquidity under extreme circumstances, through the proposal for liquidity fees and redemption gates.

We have found that some investors place more of a premium on principal stability, while others value ready access to liquidity more strongly. But, and I want to emphasize this, virtually every ICI

member tells us that no investor would purchase a floating value money market fund that was also subject to constraints on liquidity. Investors have, frankly, other less onerous options readily available to them.

Fourth, if regulators do feel that it is necessary to require some money market funds to float their values, it is critical that we address the significant burdens on investors in the tax and accounting treatment of gains and losses. This will require action by Treasury, the IRS, and perhaps even by the Congress.

Unless these issues are resolved in advance, investors are unlikely to accept floating value money market funds and significant disruption of short-term credit markets is highly likely.

And fifth, we support the Commission's recognition that its proposal should be appropriately targeted, and that funds intended for retail investors should be exempt from any requirement to impose floating NAVs. We have significant concerns, however, about the practicality and costs of the SEC's proposed definition of retail funds, based on daily redemption limits.

Instead, we recommend the use of Social Security numbers as the fundamental characteristic to identify investors eligible to invest in retail funds. This approach would be far less costly than other methods of defining retail funds and far easier for investors to understand.

In the 5 years since the financial crisis, the fund industry has strongly supported the SEC's efforts to make money market funds ever more resilient, even as they continue to play their valued and important role for investors in the economy. We appreciate deeply the support that many members of this committee and subcommittee have shown for our efforts. I look forward to your questions.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Stevens can be found on page 111 of the appendix.]

Chairman GARRETT. Thank you. And I thank the panel.

We will now go to questions, and I will recognize myself for 5 minutes.

And I will start, I guess, with Mr. McCoy. My general question is going to be what your opinion is of the effect of these rules on municipal money market funds; but, something you brought up during your testimony with regard to the LGIPs, and you said something about the banks that are—is there is an overcollateralization requirement? So, can you answer both of those questions, just quickly on the overcollateralization?

Mr. MCCOY. Yes. On the collateralization requirement, there, local investment pools no longer could remain 2a-7 like—

Chairman GARRETT. Yes.

Mr. MCCOY. —to be stable value. One of the alternatives a lot of people look at is moving money into banks.

Chairman GARRETT. Right.

Mr. MCCOY. The problem is, banks have to post collateral in mark-to-market daily to secure public deposits. And at 110 percent level, the cost of the bank, both has to be a bank that is willing to accept a public deposit, pay some rate of interest comparable to any other investment; but also, the availability.

We have found, recently, two colleges, as their deposits grew larger, working with a smaller community bank, they did not have collateral sufficient to cover those deposits, and they did ask that the accounts be moved to larger banks.

Chairman GARRETT. Okay, I can agree with that—

Mr. MCCOY. Probably in a lot of smaller communities, there are not banks available—

Chairman GARRETT. I get where you are going. Okay.

Mr. MCCOY. And then, on the other, on the municipal money market funds that we have, we do feel like that municipal security—short-term securities, should receive the same treatment as the U.S. Government obligations, as to have an exemption for them in that they are not retail funds. A lot are institutional investors, so they cannot qualify under the retail exemption the SEC has proposed. So, we have asked that they receive an exemption.

Chairman GARRETT. All right, great. Thank you.

Ms. Bair, you raised the point—an interesting one with regard to if you have the gates and the restrictions on there that may accelerate the withdraws, right?

Can't a thing be said, or can't it be said with regard to a floating NAV that if you have a floating NAV as the investor sees it—"oops, it is down, it broke the buck, so to speak, and all of the sudden, that is my first cue to pull out as well," so is one worse than the other?

Ms. BAIR. That is going to be true with any mutual fund. Frequently, what you find what you get into downturned situations is that people take their money out of lots of mutual funds. They reprice, they go into Treasuries, they fly to safety.

The issue is whether the government is going to give them an incentive to run. And so with the stable NAV, they are, because you are a smart, one of the so-called smart money and you are seeing, "Oh, the assets in this fund are only worth 97 cents, I can still get out at a dollar—I am going to go out. The government is giving me an affirmative incentive to run."

Chairman GARRETT. Okay.

Ms. BAIR. That is the inherent source of instability.

Chairman GARRETT. Another question—another point you raised during your testimony, do you believe now that the law would prohibit a bailout, if you will, and assure of the funds?

Ms. BAIR. I do.

Chairman GARRETT. Okay. That is because of—

Ms. BAIR. Because of the—yes, that was put into law—was it the TARP legislation, I think—

Chairman GARRETT. Yes.

Ms. BAIR. There is a specific statutory ban, and remember ranking others have affirmed—

Chairman GARRETT. So, what about—

Ms. BAIR. It has no intention to bail them out, they don't feel like they have authority to—

Chairman GARRETT. Yes, well, they don't have any intention to bail out of things.

So, what about under Section 13.3, would they be—if they were not an individual firm or—but as a same last time, if it is systemic to the entire economy and the Fed identifies an entire industry

that needs to be preserved or protected under 13.3, wouldn't they have the authority to do so there?

Ms. BAIR. If it is generally available, that is right. But there are special prohibitions for money market funds. So, I think, that is really—

Chairman GARRETT. So, it is a question of which law prevails, whether they—with the prohibitions, or—

Ms. BAIR. I don't know. I think that the more—the greater likelihood is if we leave this structural instability in place, and we have another problem, they are going to be coming to Congress and asking you to vote for a bailout.

That is what is going to happen, because I don't think they feel like they have the authority to do it, and so, it is going to be on Congress' head, to vote or not. This is the way it was in court and a lot of you face some tough reelections; some of you lost those, because of that vote.

Chairman GARRETT. Okay. So many more questions. Can you kind of speak to the issue?

Mr. Stevens, I think you brought it up with regard to the shadow NAV, and the effect—the positive effects that could have, and the transparency element, and I guess if you want to do them and you answered one of my questions already, would simply transparency, and I know—

Would simply the transparency aspect of the rule and putting in some temporary limitation gates be adequate?

Mr. STEVENS. If I could take the first part of that, I really would recommend to the subcommittee a report that Dennis Beresford, who is a former Chairman of the FASB, has prepared. And it examines how we maintain a stable NAV and money market funds. It is done through something called amortized cost evaluation of the securities in the portfolio.

Amortized costs is an accounting convention which is 40 years old. It is not a fiction; it is a convention. In fact, it is a convention that Ms. Bair has recommended very strongly be applied to the banking industry. But apparently in our context, it is not a convention, but a fiction. The reality is that as Beresford's report points out, the mark-to-market value of these portfolios fluctuates from $1 only infinitesimally on average, maybe a basis point or so up and down.

So the value is, in fact, I think a reality, and Beresford's report makes it clear that this is a fair way to value money market funds. It is not a fiction.

Chairman GARRETT. Okay, I am going to try to contain my time as I do with everybody else, so I appreciate that motion. If you can give me some further answers on the rest of the questions, I would appreciate it.

Mr. STEVENS. I would be happy to, Mr. Chairman.

Chairman GARRETT. The gentlelady from New York is recognized.

Mrs. MALONEY. Thank you. On the liquidity fee proposal, of the fees that are intended to deter investors from withdrawing their money in times of stress, and I would like to ask James Gilligan, in the SEC's proposal, the maximum size of the liquidity fee would be 2 percent, and as an investor, do you think a 2 percent liquidity

fee would be enough to deter you from withdrawing your money during times of crisis?

Mr. GILLIGAN. Recall in my testimony, I am not a net investor, so this is speculation on my part, but I think that liquidity gates and redemption limitations are not palatable to corporate treasurers in any sense of the word, and they would not be attracted to investing in money market funds to begin with.

That is our point, that this could destroy the product of money market funds and have repercussions that are far more extensive than what are being contemplated by imposing that. I don't frankly know if a 2 percent liquidity limit will keep people from redeeming or not. They are not going to like that there is going to be a gate on their redemptions, period.

Mrs. MALONEY. There is some proposal to raise the amount that the 2 percent is not doing the job of, Ms. Bair, you testified that this would not help, that this would make the problem worse. Do you want to elaborate, and Mr. Stevens, your comment on this too?

Ms. BAIR. I do think it would make it worse. The prospect of the agencies will again give affirmative incentive to people to get out before the gates and fees go down, and I worry that again, that is going to be the more sophisticated investors who understand what is going on.

That is why you saw retail not running, although I don't know that we can assume that won't happen again. One of the reasons retail didn't run is because the government quickly put a program in place, but they are going to be left, because, so a product that is designed for giving people the impression they have ready access to their cash, that their cash is fully protected, all of a sudden they are going to have to pay a lot of money to get their money out or perhaps even have to wait 30 days. But I think from an investor perspective, that is very ill-advised.

And the thought, I think the industry is being somewhat inconsistent by suggesting that as a good approach. On the one hand they say, "Well, this is a very, very important market," which it is. It is a huge market, despite potentially destabilizing. But on the one hand, they say, "this is very important," but then it is okay to lock it down for 30 days, and not let people pay their bills or make their payroll or whatever. That makes no sense to me, so I think this is not a good option. I hope the SEC drops it. It is an alternative to the floating NAV, and I think it is very ill-advised.

Mrs. MALONEY. And Mr. Stevens, your position on the liquidity and fees?

Mr. STEVENS. Thank you, Mrs. Maloney.

The reality is that the SEC staff report agreed with us in our recommendation with respect to the consideration of the liquidity gates and fees, that if you cast your mind back to 2008, it is the recommendation that would have stopped a cascade of redemptions.

But I would say that in the industry, no one would wish to flirt with the triggers that would impose those gates or those fees. As the SEC has conceptualized it, if a fund's weekly liquidity falls to 15 percent of its portfolio, it would then be required to consider these two measures. That would mean that weekly liquidity had fallen by 50 percent.

The requirement, if it were adopted into a rule that would be internalized by portfolio managers across the industry, would be to stay very well north of 15 percent liquidity. In fact, if you look across taxable money market funds today, their required weekly liquidity is $700 billion. Their actual weekly liquid assets maintained in their portfolios as of July was $1.3 trillion.

Mrs. MALONEY. And I would like to get Mr. McCoy's comment on this, and also, does anyone know where these fees go? The rule was very vague in where these fees go. Where do they go? Does anyone know? Just in the general Treasury? It doesn't say where it goes.

Ms. BAIR. They go back into the fund.

Mrs. MALONEY. Pardon me?

Ms. BAIR. They go back to the fund.

Mrs. MALONEY. They go back to the fund, and would be distributed among the other people?

Ms. BAIR. Yes.

Mrs. MALONEY. Mr. McCoy, your position on the—

Mr. MCCOY. I know that is correct on money market funds. There is a concern on most of investment pools as to who we even legally impose liquidity fees, or gates in that could we actually take money from some local governments that are behaving one way, they want their money out, and pay it to others that are staying in.

Mrs. MALONEY. And on the floating NAV, can anyone estimate the average variability in the NAV of time funds if the SEC adopts the floating NAV plan. What does it mean? If it is near $1 or near $10, would they shift to that area? Any comments—

Mr. STEVENS. Can I take a try at it? Actually, in order to force these funds' portfolios to float, for their NAVs to vary, the SEC is actually proposing a valuation method which is not characteristic of mutual funds, generally. It would require these funds to basis point round their portfolios 4 places to the right of the decimal. That requirement is intended to force a float which the normal pricing of mutual funds' experience would not display.

So it shows you the portfolios here are really quite stable, and in order to make them float at all, the SEC has to depart from what is the convention with respect to other funds.

Mrs. MALONEY. Thank you. Any other comments?

Chairman GARRETT. No, and with that, the gentleman from Virginia is recognized.

Mr. HURT. Thank you, Mr. Chairman. I wanted to ask Chairman Bair, who obviously is very familiar with what happened in 2008 and was on the ground, if either or both of these proposals were in place in 2008, can you kind of walk us through what you think would have been the effect, and whether or not this would have had, either of them would have had a positive effect, why or why not?

The second thing I was hoping you could also offer up is your view of how this regulatory proposal fits into what is being developed overseas and in other countries, and how that affects our competitiveness?

Ms. BAIR. Right. So I think the gates and fees would have made it worse. I think the floating NAV—look, if we never had this special SEC rule that allows a stable NAV, I don't think you would

have seen such a huge shadow market develop. I don't think you would have seen other financial institutions that were relying on short-term money, so I think if we had that, the money fund industry from the get-go would be smaller, and I think it would have behaved like other money funds.

You would have seen a lot of redemptions. You would have seen a flight to quality. You see, that is how markets work. They reprice in times of stress, but no, I don't think we would have had or seen the implosion that we had in 2008.

This proposal, I believe, is weaker than what they are talking about in Europe. They are saying do a floating NAV or have 3 percent capital. If you want to have a stable NAV, you want to promise your investors you are going to have a dollar no matter what, put some capital behind it. They are saying 3 percent, so—

Mr. HURT. So what is your view of the effect of our competitiveness, and what is available to the folks that Mr. Gilligan is speaking for in terms of having an efficient marketplace, and being able to have the most choices for the least cost?

Ms. BAIR. So look, implicit government subsidies always allow people to do business more cheaply. Guarantees of that capital behind them always allow people to do business more cheaply, but those models work until they don't, and they don't work in times of distress. So I think you need to think how it works in good times, which is it saves everybody money, and how it works in bad times, when it costs taxpayers, we know it did cost or forced them to take a lot of risk. Fortunately, it didn't end up costing anything.

So I think that those are the tradeoffs you have to make, and again Europe is being tougher, and they don't seem to be worried about putting themselves in a less competitive position to us.

Mr. HURT. I also wanted to ask Ms. Chandoha, Mr. Gilligan and Mr. Stevens about what Mr. Gilligan testified to, and that was that the floating NAV proposal would deprive significant choices and impose significant costs.

Ms. Chandoha, you testified that clearly the imposition of these rules or the floating NAV proposal would lead to migration out of money market funds. How do you respond to that concern that the cost is greater than the benefit at the end of the day? Are you able to respond to that, and then I would love to hear follow up from Mr. Gilligan and Mr. Stevens on that question.

Ms. CHANDOHA. We really feel the 2010 reforms strengthened the money fund industry, but there still remain some perceived risks in the money fund industry. We think the SEC has taken an approach to identify the remaining areas of risk in the money fund industry, and we feel that the proposal will have an impact on corporate treasurers. I think there was an eloquent discussion of that, and we do think that there will be shrinkage of the industry. So there will be some costs, but it will reduce some of the perceived risks of the industry.

Mr. HURT. Okay.

Mr. GILLIGAN. My response is, the floating NAV is not a solution to what I think the problem is that is trying to be solved, which is a run on money market funds.

I implore everyone to consider, even if you go back to 2008, when the reserve fund broke the buck, and we had a flight to quality

from investors who withdrew significant amounts of money from money market funds—all money market funds. The commercial paper market froze in 2008. So, that is an example that I hold out to you of what I think will happen to money market funds for different reasons.

You impose these new regulations, they make them unattractive to investors, you will see them move funds out of the money market funds. You will see a complete freeze-up of the commercial paper market, like we saw in 2008, which will drive companies like mine to higher-cost alternatives, which will have an immediate impact on borrowing costs—which, in our industry, will eventually—

Mr. HURT. Thank you.

Mr. GILLIGAN. —get passed down into our rate payers—

Mr. HURT. Got it.

Mr. GILLIGAN. —and out of the pocketbooks.

Mr. HURT. Thank you, Mr. Gilligan.

Mr. Stevens, I apologize, but my time has expired.

Chairman GARRETT. The gentleman yields back.

Next, Mr. Ellison is recognized for 5 minutes.

Mr. ELLISON. Thank you, Mr. Chairman. And I wanted to thank all the panelists.

Ms. Chandoha, I have a question for you. And I want to thank you for being here today.

In 2011, Schwab became the first and only brokerage to insert clauses into your customer service contracts banning your customers from participating in any class-action lawsuit against your company. This is in addition to the requirement in your agreements, which is also used by other brokerages, mandating that disputes with individual clients be settled through arbitration.

Your regulator, FINRA, is challenging the legality of your class-action waiver as a violation of its member rules. And I believe your firm issued a statement on your Web site on May 15th—which I can't locate now, by the way—announcing a temporary suspension of the practice pending the resolution of the FINRA action against you.

My question is why Schwab, alone among brokers, feels that its clients should have to give up their right to participate in its class actions?

Ms. CHANDOHA. I run the Asset Management Subsidiary of the Charles Schwab Corporation. The broker-dealer is a different subsidiary, so I am not the right person to answer that question. I am not very familiar with that particular issue. But we can certainly have someone get back to you on that, and answer that question.

Mr. ELLISON. I would appreciate that. I would just like to put a few other questions on the record for you. Maybe you can answer them, maybe you can't. But I would like to also know why Schwab can't put an end to this practice of not allowing their customers to participate in any class-action lawsuit.

And then also, if Schwab is successful in stopping FINRA's legal challenge, is Schwab planning to re-insert the class-action waiver into the account agreements? Are those questions you can answer?

Ms. CHANDOHA. Those aren't questions that I can answer, but we will certainly take those questions back, and we will have someone get back to you on that.

Mr. ELLISON. And also, I am curious to know if Schwab is going to re-evaluate whether taking away the right to go to court is fair to customers. So, I assume you can't answer that question, but I assume also that you will bring it back to the people who can.

Ms. CHANDOHA. Yes, we will.

Mr. ELLISON. And I would also just like to express my concern about small investors having access to the courts. Putting aside the question of whether or not it is legal, I would like to know whether you believe, or whether you can get back to me on whether or not you believe it is fair for small investors to be forced to waive all rights to go to court to settle disputes before a dispute even occurs or can be understood against a company of significant size such as Schwab?

Again, I am sure, this is for the record, and I am urging you to take it back. And I also want to express my concern that Charles Schwab believes it can establish a trusted relationship with clients while requiring every single one of its clients to give up its legal rights to go to court before they can work with you.

So, I would like to just put those questions on the record. I will submit them to you in writing. And I just want to make it clear that this is an issue I am quite concerned about. Actually, we have crafted some legislation to address the issue. And I just want to underscore that we believe that the small investor needs to have a voice, and our concern about the practices in which Schwab is engaged.

So, thank you for being as responsive as you can today. But please convey to your colleagues this is an ongoing issue, and this is not going to be dropped.

Also, I would like to point out that I think this whole issue underscores why Congress sought to restrict the use of these contracts in Dodd-Frank, Section 921, and why we probably should have gone further. And it is also, again, why I introduced H.R. 2998, the Investor Choice Act, which would prohibit such forced arbitration contracts, when used by brokers to abridge the rights of their clients.

And so, Mr. Chairman, whether by statute or the legislation or rule, the Federal Government has a duty to see that arbitration is not abused, and that investor rights are not further eroded by these types of clauses in broker-dealer contracts.

So, thank you.

I think I have—I am on my yellow light, so I would like to direct a question to Chairwoman Bair.

Could you offer your views, ma'am, on how you would evaluate this proposed rule from the SEC with the three proposed reform alternatives set forth by the Financial Stability Oversight Council?

Mr. HURT [presiding]. Mr. Ellison, what I am going to do is, I am going to ask that the witness respond in writing. And if we have time at the end, we can—

Mr. ELLISON. Oh, yes. I see we are at the red light—

Mr. HURT. So, time has expired.

Mr. ELLISON. Thank you. I yield back the time I don't have. Thank you.

Mr. HURT. Thank you, Mr. Ellison.

Next, Mr. Stivers is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. And thank you to the witnesses for being here.

I want to follow up on something that the chairman of the subcommittee asked before he left. And I would like all the witnesses to sort of go down and give me their view of this issue.

I believe that a floating net asset value will actually exacerbate the problem, because it will encourage people to redeem as soon as possible, because the risk is that your money will be worth less tomorrow, or 5 minutes from now, or whatever.

So, I guess I want to ask all the way down the panel what your view is on that. I believe it makes the problem worse, not better, as far as rush to redemption. Could each witness tell me their opinion on whether they think it makes the problem better or worse?

Mr. MCCOY. We believe it would make the problem worse. And as institutional investors, we are concerned that it would make the problem worse. We also believe that the nuances of daily pricing—it will create some problems and confusion in the marketplace. It does not give time for any pricing errors to be reconciles and mitigated before damages are done.

And so, we do think there are a lot of issues. We think it would make the problem worse.

Mr. STIVERS. Thank you.

Ms. BAIR. A floating NAV would make the problem—it deals with the core problem, which is that, with a stable NAV, if it is only worth 97 cents, you can pull out of the dollar. You are given an affirmative incentive to run.

Markets reprice all the time, but if you get with a floating NAV, if you get it out, you will have to take a loss.

Ms. CHANDOHA. We do think a floating NAV will increase the transparency. Schwab voluntarily chose to disclose our shadow NAV's earlier this year, so we do think that helps transparency, and reduces the surprise factor. So, if there is a discrepancy between the—

Mr. STIVERS. My question is, will it increase the race to redemption, not does it increase transparency. Could you answer that question?

Ms. CHANDOHA. Yes. I do think it helps mitigate the run risk.

Mr. STIVERS. Okay.

Mr. GILLIGAN. I agree very strongly with you, sir. And also, I would echo the comments of Mr. McCoy.

Mr. STEVENS. We actually saw during the financial crisis funds that had floating net asset values per share experience massive redemptions. French money funds that had variable NAV's experienced them. Short-term bond funds in the United States experienced them.

And more generally, we think that what happened with the Reserve Primary Fund was not attributable to its "breaking a buck." It was a flight to quality. It was a flight to Treasuries and other quality instruments that was characteristic of the broad market.

Two-thirds of all the dollars that flowed out of U.S. prime funds during that period flowed into Treasury and government agency funds. So, I don't think it was a fear of the "breaking the buck." It was a general preference for safer assets. And if the Reserve Pri-

mary Fund had been floating at the time, you still would have found that a factor.

Mr. STIVERS. Thank you.

Ms. Bair, if the floating net asset value results in a massive change in the size of the money market mutual funds market, which it probably will, from, say, $3 trillion to $1 trillion, and $2 trillion flows into banks that are government-insured with a government guarantee, doesn't that exacerbate the too-big-to-fail problem we have?

Ms. BAIR. The deposit limit is $250,000, so those are going to be uninsured deposits. And I don't know if that is where it is going to go. I am skeptical of some industry, not every one—some industry's predictions that this is going to result in a massive downsizing of the money fund industry. There will be some downsizing.

Mr. STIVERS. But there is a government guarantee up to $250,000.

Ms. BAIR. Up to $250,000. And there is also—the banks—unlike the—banks aren't perfect. And I am not singling out money funds. There are a lot of reforms I would like to see with banks. The deposits—we do not have a systemic problem with deposits. Deposits have not run. Because we have a whole elaborate system of deposit insurance of access and Federal reserve lending. Banks have to hold capital and unsecured debt, which by statute, take first loss before you can get to deposits.

So, that part of the banking system works well.

Mr. STIVERS. But it makes the banks bigger if the funds flow to the banks? That is correct, isn't it?

Ms. BAIR. If those deposits flow into banks, yes, it will. Yes.

Mr. STIVERS. Thank you.

The next question I have is for the two treasurers, Mr. Gilligan, and then the State treasurer, about what would happen—what would you do if you didn't have a stable net asset value in money market mutual funds? Would you be able to use them to invest in?

Mr. Treasurer?

Mr. MCCOY. At the State of Georgia, our focus would be—because—at the local governments cannot invest in straight and in privately managed money market funds. They can invest in the State and local government investment pool.

If we could not operate the stable value, we would explore how to operate as a stable value.

It may not be a 2a-7 light fund, but we could not under the current State laws, and I don't think it would be prudent to change our State laws to take away the preservation of principal as a top priority to actually move to a floating NAV. So we would explore how to restructure local government investment pools, as I think other States would too.

I think also I would like to comment—

Mr. HURT. Mr. McCoy?

Mr. MCCOY. —on your other question. Banks are—there are also—

Mr. HURT. Mr. McCoy?

Mr. MCCOY. —bank stiff funds.

Mr. HURT. The time of the gentleman has expired. Thank you for your answer. The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. I realize it is a bit unfair to my colleagues to just walk in right before it is time for my questions. I just arrived at the airport half an hour ago. It was pretty meaningless anyway.

In crisis circumstances, the funds may have been worth quite a bit different than the exact $1. But today, how big is the variation? Are we talking about every fund being between a dollar and a tenth of a penny or minus a tenth of a penny? Or if we really knew the shadow NAVs, how big a difference is there? Chairman Bair?

Ms. CHANDOHA. I can answer that question. The variability is very minuscule. It is out several decimal places and is in the range of a tenth of a penny. So, it is very tiny.

Mr. SHERMAN. But if you have $10 million to invest and you just have to move your money from a fund where you are down a tenth of a penny per dollar over to a fund where you are up a tenth of a penny per dollar, if you have $10 million, that—

Ms. CHANDOHA. There are very few funds right now which are below a dollar. Most funds are above a dollar.

Mr. SHERMAN. Above a dollar by more than a tenth of a penny?

Ms. CHANDOHA. In that range. But it is very, very small around a dollar.

Mr. SHERMAN. Could we meet the needs for stable investment vehicles if we had a fixed dollar on U.S. Government investing funds, Mr. McCoy?

Mr. MCCOY. For governments, no. Local governments and State governments, no. In fact, we would run into a problem if it was a government-only fund during a period like we had last September, I think it was September 28th, when Treasuries went into negative rates for a short period of time when there was a flight to quality.

We cannot buy a security that would have a loss in principal. And so actually when you have negative interest rates, which we have seen in some European countries and we have seen for one day in U.S. short-term Treasuries, that they really would not be even applicable or eligible for us to purchase.

Ms. BAIR. I think—was your question with this, a stable NAV with government funds, would that actually meet the need of having payment processing which would be less risky than prime funds? And I think that is a question—

Mr. SHERMAN. Yes. Thank you for restating the question.

Mr. MCCOY. But from our perspective, it would be that we could not necessarily manage a local government investment pool with government only and meet the qualifications because we may have to—

Mr. SHERMAN. Because of what?

Mr. MCCOY. Because the requirement of the amount of U.S. Treasuries that we would have to keep short, if we see a flight to quality that we—for instance, managing a local government investment pool, some of the—

Mr. SHERMAN. If I can interrupt, are you referring to circumstances where the government paper has a negative yield?

Mr. MCCOY. That is one. Also, we do have some other requirements for State governments in managing pools. For instance, our bank deposits would not qualify. So there are a lot of issues with local government investment pools that is not an option.

Mr. SHERMAN. Does anyone else on the panel have a comment on that?

Ms. BAIR. I think that is a great question. As I say, I think there are significant downsides to letting—using a stable NAV for government funds which I articulated in my testimony.

But I do think for those who suggest that the SEC's proposal is somehow going to disrupt the ability of large corporations or municipalities or whatever to have a place for—with a stable NAV for payment processing, they could use government funds under the SEC proposal. I think that is a good thing to note.

Mr. SHERMAN. Okay. I want to yield the rest of my time to the gentleman from Massachusetts.

Mr. LYNCH. Okay, thank you. This is going to be a great opportunity. First of all, I want to thank all of the panelists. You have offered some very thoughtful testimony here.

Ms. Bair, in your expanded written testimony, you really do point to the stable NAV as the culprit and the inducement to run. Now if Mr. Stevens and what my colleague Mr. Sherman has suggested, if this differential is very small, isn't that an insurable risk?

If the delta is so small, why can't we have insurance for those parties investing in these funds so that if we did bump up against the dollar the insurance would kick in? There wouldn't be an inducement to run. The delta would be insured and we wouldn't have the flight to quality that we see now, or am I just moving the goal post?

Mr. HURT. Mr. Lynch, I think your time has expired. Mr. Sherman's time has expired. What I would like to do is recognize Mr. Hultgren for 5 minutes, and then the witness can answer your question.

Mr. LYNCH. Sure, that's great. Okay, fair enough. Thank you.

Mr. HURT. The gentleman from Illinois is recognized for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman. Thank you all for being here again. I think this is a very important topic that I certainly want to understand, and I know my colleagues do as well.

And just to recap, I think my understanding is pretty clear from your testimony, from the questions that certainly for investors two of the most attractive features of money market funds are stable NAV and also liquidity.

It also seems fair to say that these features, if they are compromised by floating the NAV or imposing gates or fees, we would likely see—most of you had said this—we would see money flow out of the products and we would see less demand for money market funds.

Mr. Stevens, I wondered, this movement out of money market funds, would that also be seen in institutional prime funds as well as municipal funds?

Mr. STEVENS. I think it would be across-the-board, assuming that the requirements were applied uniformly, particularly if they were

applied in combination. And we have given a lot of thought over these past 5 years to where the money would go.

One of the convictions I think, particularly for retail investors, is that it would flow into bank deposits and probably be concentrated in the largest of our banks. With respect to institutions which have more alternatives, there are private funds that they could use. There are offshore vehicles that they could use. None of them have the transparency or the regulation that are characteristic of today's money market—

Mr. HULTGREN. Treasurer McCoy, if I can ask you a quick question, if we expect an exodus of investors from municipal tax-exempt funds, couldn't this mean a cost spike for State and local government financing?

Mr. MCCOY. It would. Anything that would reduce the demand for our issuance of bonds would increase our borrowing cost.

Mr. HULTGREN. So it is really—the potential is the new rules could indirectly burden our constituents, the taxpayers, with highest costs for States and municipalities. Is that true?

Mr. MCCOY. Absolutely. It would drive up our borrowing costs.

Mr. HULTGREN. Okay. Mr. Stevens, jumping back to you, quoting from your testimony, the SEC—as you stated—released proposals to exempt government money market funds from further structural reform because of, among other things, the following: Government money market funds are not susceptible to the risks of mass investor redemptions. Their securities have low default risk and high liquidity, and interest rate risk is generally mitigated.

Could the same be said of municipal funds as well?

Mr. STEVENS. Yes. In fact, we believe that the municipal security market reflects many of those same characteristics. In addition, we have looked at the Detroit bankruptcy, the experience in September of 2008, and the problems in Orange County historically and have discovered that those major shocks in the market did not precipitate outflows en masse from tax-exempt money market funds.

Mr. HULTGREN. Ms. Chandoha, in your testimony, I gather that you would agree with ICI's conclusion that municipal money market funds are particularly resilient, to quote your testimony, and don't pose a systemic risk. Is that true?

Ms. CHANDOHA. That is true. I agree with what Paul said, that the municipal money funds are much more liquid than prime funds, so they are far more resilient. They proved that in the financial crisis. We didn't really see flows there.

They are also—they represent 10 percent of the whole money fund industry, so they are very small relative to the entire industry, but yet have outsized importance for State and local governments to finance themselves.

Mr. HULTGREN. Okay. Treasurer McCoy, I wonder if you could help me further understand. I have met with some State treasurers, but I want to ask if you could briefly lay out the implications of the SEC's proposal for local government investment pools, or LGIPs.

The LGIP structure won't be familiar to everyone here, and I believe the effects of the SEC's alternative proposals certainly could pose a significant risk to participants in LGIPs, potentially harm-

ing the finances of those municipal entities. Could you tell us just briefly—I only have a few seconds left—if you see this as a potential harm and a concern we ought to have?

Mr. MCCOY. I think every State that manages an LGIP would look at this very seriously.

I think that we will—as State treasurers, we would work with GASB to see if we could encourage GASB to change their rule to be more like the office of the OCC rule for bank stiff funds, which does describe—or require a stable NAV by using amortized cost accounting. So it would, we would be moving in that direction to see if we couldn't get some relief there.

Mr. HULTGREN. My time is about to run out. I am going to ask if I can follow up with some written questions and ask for your response. One in particular is NAST, concerned with the SEC's proposed elimination of the 25 percent basket, returning to a 10 percent limit, effectively could cap municipal debt held by a single MMF regardless of creditworthiness.

So I have some questions about the impact, again, on taxpayers, on our constituents. My time has expired, and I yield back. Thank you all very much.

Mr. HURT. The gentleman's time has expired. And the Chair now recognizes Mr. Lynch for 5 minutes.

Mr. LYNCH. Thank you. Again, if I could go back to my question, Ms. Bair, it is sort of two dimensional. One is, would we be able to ensure the risk of breaking the buck to remove that inducement to run?

And the other is, by creating an insurable situation there, you would allow the insurance company to actually look at the quality of the assets within the fund in setting the insurance rate. Is that something you had considered? And I do appreciate the courage of your position. You are not the most popular person in the room, but I do appreciate your candor, your honesty.

Ms. BAIR. So this would be using a private insurance or government insurance program?

Mr. LYNCH. Either way. The SEC is now talking about fees—

Ms. BAIR. Right.

Mr. LYNCH. Redemption fees—

Ms. BAIR. Right, right.

Mr. LYNCH. If you are going to charge them.

Ms. BAIR. Right. I think if policymakers decide that we need the fund industry as it is because of the payment processing services it provides, especially for large corporate users and governments, to do it up front with some type of insurance program that you pay for is the best way to do it.

I am not advocating that, but I am saying if you want this industry to continue the way it has been, which now has an implicit government guarantee, frankly, a guarantee without any capital behind it, nothing behind it except kind of a wing and a prayer, that would be the way to go.

I am not advocating that, but if you want this industry to continue the way it is with the stable NAV for a wide variety of large corporate users in particular, that would be a better approach than to leave things the way they are.

Mr. LYNCH. Thank you. And let me ask you, Ms. Chandoha has recommended—and again, this is for you, Ms. Bair—in her testimony that municipal MMFs, money market funds, be exempt from the floating NAV requirement.

And there is a public purpose in terms of the municipals that is undeniable, and I worry. I have a letter here from the Massachusetts Municipal Association. I will ask unanimous consent to enter that into the record.

And also, a letter from Governor Patrick—

Mr. HURT. Without objection, it is so ordered.

Mr. LYNCH. —arguing against the floating NAV. So, what are your thoughts on that in terms of exempting them?

Ms. BAIR. I don't like the government securities generally, so I would take it all out. I would say that the argument is stronger for a Treasury-only fund than it is for GSEs.

And I am sorry you have credit risk with municipal debt, you do. You certainly have interest rate risk with all of them. So, no, I would just like to get rid of that exception for government funds. But I certainly wouldn't want to expand it.

Mr. LYNCH. Okay. And, lastly, again, this has been touched on several times. I just looked at the size of the 10 biggest banks back in 2008, for those that are still around and a lot of them are not. On average, they have increased 40 percent in size between 2008 and 2013.

And I am just concerned about this too-big-to-fail problem. If we are going to create safeguards, that does induce folks to get out of money markets, and if they do run to banks, are we creating even a bigger problem on that end?

Ms. BAIR. I don't know where the money would go. I don't know that it would go to the largest banks. I think, typically, when I was at the FDIC, we saw a lot of volatility with community bank deposits depending on where the money fund rates—returns were.

So, I think there is—definitely if you are worried about competitive issues, it is not clear to me at all that this is going to be benefiting the big banks. I would say, though, this is—

Mr. LYNCH. If I could, I think in the money market space, we have seen the size of sponsors—

Ms. BAIR. Certainly, on the retail level—

Mr. LYNCH. Influence.

Ms. BAIR. On the institutional level—

Mr. LYNCH. Yes.

Ms. BAIR. Yes, you would assume that very large accounts, I would assume, would go to the larger banks. For the retail level, I don't know if that is the case.

So, look, this is not about—I think there is a perception—or those who want to keep the status quo want people to think this is bank-driven or bank regulator-driven.

This is system stability-driven. I don't think the big banks are not supporting this. A couple have weighed in on the side of the fund industry because they have their own money funds. They have more deposits than they know what to do with already. So, I don't think they are driving this. I think what this is about is system stability. You have a banking system, albeit imperfect, and it needs changes, too.

But, on the deposit side, it worked pretty well, and the reason is because you have a number of safeguards like deposit insurance, like Federal Reserve Board lending, like capital and unsecured debt that takes first loss before deposits would ever be hurt, which is why deposits mostly suck even the uninsured stuff.

So, it is whether you want a shadow bank or not. You have a shadow bank that works in good times and it doesn't work in bad times. So, if you want to keep this, then you are right, go with some kind of government—

Mr. LYNCH. Thank you—

Ms. BAIR. —insurance program for that.

Mr. LYNCH. I yield back. Thank you for your courtesy.

Mr. HURT. Thank you, Ms. Bair.

The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman.

I fully admit that this is not something which is readily intuitive to most folks. I am not very familiar with it, so I appreciate all of you taking the time to help us get up to speed.

When I deal with things that I don't readily understand, I like to go back to the very beginning of the issue.

And it strikes me that we are here and the SEC is proposing these rules, if I get this right, in order to prevent future runs on money market accounts. That is a fair statement, right?

But yet, I hear Mr. Stevens then turn around and tell me that there was no run in 2008 on these money market funds, there was no run when Orange County went under on these money market funds several years ago.

Mr. Stevens, you are shaking your head no, but I thought you said that there was no run on these accounts several years ago.

Is this a solution looking for a problem? Why are we even talking about these things?

Mr. STEVENS. No, I believe, Congressman, what I said was that the problems experienced in prime money market funds in 2008 have been attributed to one fund breaking a dollar.

Mr. MULVANEY. Right, just one.

Mr. STEVENS. Just one. The reality is that before the Reserve Primary Fund broke a dollar, 13 major financial institutions had collapsed or required a government bailout.

Lehman Brothers went bankrupt, and the day the Reserve Primary Fund broke a buck, AIG was taken out. There was not a characteristic of money funds that was at issue. It was, in fact, a general flight to quality by all investors in the market. Remember, in those days, the banks wouldn't even lend to one another.

So, what we saw is investors, very deliberately, leaving exposure to commercial paper and other assets that were opaque, including bank assets, bank-issued debt, and they were moving instead to the safety of Treasury and government agency securities, and one of the ways that they did so is by investing in Treasury and government agency money market funds.

We interpret this to mean that it wasn't a structural issue with money market funds. It was, in fact, a basic problem in the commercial paper markets that all investors, including ours, were reacting to.

So, we certainly had outflows, but the commercial paper markets were experiencing them across-the-board.

Mr. MULVANEY. Thank you for that clarification.

And to the extent that this is something which needs to be dealt with, tell me, Mr. Stevens—and I heard Mr. Gilligan say that a lot of funds have already offered—are starting to offer shadow NAVs.

We have heard other folks testify today about funds offering voluntary—or talking about proposing voluntary gates and fees. Doesn't that voluntary system solve the problem just as well?

If you had a shadow NAV with voluntary gates and fees, doesn't that accomplish the same thing?

Mr. STEVENS. We think disclosure can go a long way without having a requirement that we float the NAV to inform investors, since that is what many proponents of a floating NAV argue, to make them clear in their own minds that this is an investment product that can change in value.

Some of our members have voluntarily started to do that. If the SEC were to require it across-the-board, that is something we could support.

Mr. MULVANEY. So my understanding is that if you do the shadow NAV instead of actually mandating it, it does avoid some accounting and tax issues.

Mr. STEVENS. Yes, if you allow the transactional value to remain stable within the confines of the current rule, what you have is, you are sparing investors the need to keep track of infinitesimal capital gains and losses over time. Money market funds aren't like other mutual funds in the sense that you may buy a mutual fund, a stock or a bond or a hybrid fund today, and hold it for a long period of time.

But, for a money market fund, you can be in and out of that constantly. Certainly, Schwab's customers are a great example of that, in Marie's testimony.

And if you had a floating NAV, each one of those would have to keep track of minuscule gains and losses each time and report them to Uncle Sam. It would be a paper chase nightmare for tax compliance.

And that is one of the reasons, I think, that money market funds are so popular because of the convenience that they provide through that stable $1.00 per share value base.

Mr. MULVANEY. Thank you, Mr. Stevens.

Mr. McCoy, I want to get back to you very briefly. I have 45 seconds left. At the very end of your testimony, you were saying something very interesting to me which is the impact especially of these proposed rules on small and rural communities.

Could you finish that testimony please because that—you just described most of my district?

Mr. MCCOY. Yes, sir. Thank you.

Those will be the communities we think will be most impacted, that your large metropolitan communities gain great benefit from local government investment pools, but many of those could adapt more easily.

They have larger financial institutions in their community that they have banking relationships with that would work with them to accept deposits. Also, they do have some trained investment

staff, and with very good systems, they could move to develop to buy securities directly.

The smaller ones will not have the staff or the resources to look for alternatives. They will end up taking more concentration risk in securities instead of having a diversified portfolio in a local government investment pool.

And often not have banks that would have sufficient collateral to accept their deposits.

Mr. MULVANEY. Thank you, Mr. McCoy.

Thank you, Mr. Chairman.

Mr. HURT. The gentleman's time has expired.

The Chair now recognizes the gentlelady from Wisconsin, Ms. Moore, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

I thank the witnesses for appearing here today. I can't remember if it was Mr. Gilligan or Mr. Stevens who indicated that were we to float the NAV, there would be a lot of institutional investors that would flee from the money market funds and would go to alternative products.

So, you guys are going to have to remind me who said that.

And I guess I would like to know, what that would be? We have heard a lot discussion here today that they wouldn't necessarily go to banks. Banks are overcapitalized, they have record deposits and don't really necessarily want the money.

So, thank you for helping me recall who said that.

Mr. GILLIGAN. Yes, ma'am. I think I spoke to that.

I think the answer to your question is I don't really know where these deposits are going to flow to; no one really knows.

Ms. MOORE. Would they go off-shore perhaps?

Mr. GILLIGAN. They definitely could go off-shore. I think they will go to a number of different places. I think funds will flow to banks, which has been stated already have a lot of deposits and have grown in size.

I think there will be some off-shore movement into nonregulated funds. I think there will be some transition into muni funds, govi funds, but I don't even know that they are going—those funds are going to have the capacity or underlying financial instruments to take the prime institutional money that will free up—that will move out of there.

So, it is a good question. No one knows.

Ms. MOORE. And then, I would ask Ms. Bair, are we pooling risk into—you said that they wouldn't necessarily go to the biggest banks, but you acknowledged that they probably would.

Are we just moving risk into government-backed banking institutions? Wouldn't risk pool there, if it were to go to those banks?

Ms. BAIR. Again, the banking system is made, first and foremost, for a safe place to put ready cash; cash you need to move in and out on a quick basis, that maintains stable value—that is what banks are supposed to do. Money funds are somewhat of a shadow bank in that regard.

So, the fact that it would go to banks is not—that is what the banking system is supposed to do. I think Mr. Gilligan has some good arguments with the suggestion that money fund investors are

going to go to some shadow hedge fund in the Cayman Islands, it just doesn't pass the lab test.

Money market fund investors are somewhat risk-averse. They are going to be looking for safe places. And so, I can't believe that this is going to go into the shadow sector; we have already talked about Europe, which is proposing tougher standards. So, I do think he has some good, very good arguments, which he has articulated very well.

This one, I don't see any shadow banks out there that are going to be attractive to the kind of investors who put money in money funds.

Ms. MOORE. Okay, thank you for that.

I have a couple of other questions for whoever wants to answer—feels adequate to answer it, I would invite them to answer it. Do we have any clarity from the IRS on the accounting consequences of floating the NAV?

Yes, sir, Mr. Stevens?

Mr. STEVENS. Congresswoman, we have had discussions on behalf of the industry with both Treasury and the IRS. They are certainly aware of the issues that we have focused our concerns on if we go to a floating NAV. And, they have tried, at least, to be forthcoming.

One problem is something called the wash sale rule—if you are transacting and you are in and out, and you sustain a period of losses and then you reinvest, they have said that they would waive the wash sale requirements, but the taxpayer would still have to keep track of all of the transactions in order to determine whether they are within the exemption that is being discussed.

So, the administrative burdens are going to remain. And while that is at least promising, it doesn't really resolve the heart of the problem.

Ms. MOORE. Right. We are obviously going to see the money market fund really shrink considerably. And if the only investors in there would be maybe municipal bonds, who are treated more like corporate bonds than they are Treasury bonds, what impact will this have on changing or maintaining the low-risk profile of municipal bonds?

Mr. MCCOY. The question is whether the change on the municipal bonds—I am trying to make sure I understand the question—as to the impact on municipal bonds—

Ms. MOORE. If they are just a primary customer, as everybody else is gone—I am assuming that others would leave and go to big banks—does that change the risk profile?

Mr. MCCOY. It would not change the risk profile of the bond issuers, it would change the appetite of the investors. And—

Ms. MOORE. Okay.

Mr. MCCOY. So, it would remove the largest purchaser of tax-exempt bonds if the—if municipal money market—

Mr. HURT. Thank you, Mr. McCoy.

Mr. MCCOY. —demand there are a large purchaser.

Mr. HURT. Thank you, Mr. McCoy.

Ms. MOORE. And thank you, Mr. Chairman, for your indulgence.

Mr. HURT. The gentlelady's time has expired.

The Chair now recognizes Mrs. Wagner for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman, and thank you to our witnesses.

This is going to be directed to Mr. Stevens. If the logic behind the SEC's proposal for floating NAV was simply to provide more transparency or to remove the unique ability of money market funds to hold their NAV constant, then I think, perhaps, the SEC's proposal might have some level of merit. But, as we know, that is not the primary argument that the SEC made.

As they noted in their rule proposal, the floating NAV is designed primarily to "address the incentive of money market fund shareholders to redeem shares in times of fund and market stress." The SEC believes that this would, I guess, address any contagion or systemic risk issues surrounding money market funds.

So, my question, Mr. Stevens, is does the solution fight the problem? If there are real concerns about investor redemptions and systemic risks during times of stress, is a floating NAV the appropriate response?

Mr. STEVENS. We have been on record on this subject continually since 2009, and it has been remarkable how many voices there are who say that all we need to do is float the net asset value per share. Certainly, some voices at the SEC, and the Federal Reserve Bank Presidents recently have said that is the prescription.

We have always wondered whether that would stop a massive redemption out of a money market fund vehicle in the circumstances that we faced in 2008 when basically, people were trying to flee from a certain asset class and to find a safer haven for their investor dollars.

Nonetheless, it remains one of the two core proposals that the SEC has put in place. And so, our members have been trying to figure out which is better, from the point of view of the investors we are serving—a floating NAV per share, or redemption gates and fees?

Mrs. WAGNER. If a floating NAV caused investors to pull money out of money market funds, is it reasonable to believe that a lot of the money would flow into FDIC-insured bank accounts?

Mr. STEVENS. We have been on the record about where the money would go to, and it is a complex analysis. For retail customers, they really will have no alternative, I think, except for deposits. So, they will go to banks.

Institutions have lots of other alternatives, and while Ms. Bair kind of dispenses with the notion that there are offshore and other kinds of markets, those actually already exist for institutional investors, and they don't have the transparency, they don't have the regulations around them.

But if they can provide a current money market rate of return and a stable net asset value for large investors, they will be a very attractive alternative to uninsured bank deposits, for example.

Mrs. WAGNER. So, if we are looking at money market reform from the standpoint of taxpayer protection, the SEC's proposal could actually create a scenario where funds flow from a product that currently does not enjoy a taxpayer guarantee to bank deposits, which have an explicit taxpayer backing. Is that correct?

Mr. STEVENS. We have expressed that concern, as well.

Mrs. WAGNER. Wouldn't this end up creating more risk for taxpayers and perhaps even exacerbate the too-big-to-fail problem?

Mr. STEVENS. It certainly—remember, we are talking about $2.6 trillion in—that is intermediated through money market mutual funds today. That is a big number.

And so, if a substantial portion of that were to go back into the banking system, some substantial portion of that clearly would be going to our largest banks. I think, to the extent that raises the concern you are suggesting, it may create a risk elsewhere.

Mrs. WAGNER. Thank you.

Mr. Gilligan, you have an important perspective in this debate in that you are here representing Main Street companies that both invest in money market funds but also issue commercial paper that is bought by money market funds and is essential to financing operations.

You noted in your testimony that, "Corporate treasurers and financial professionals understand the risk of investing in money market funds, and that investments in these funds is not guaranteed by the U.S. Government." Do you believe the SEC's proposal for floating NAV will somehow uncover hidden risks of money market funds that corporate treasurers and other institutional investors aren't already aware of?

Mr. GILLIGAN. Absolutely not. And I argue a little bit with this notion that investors believe there is an implicit guarantee, anyway, of money market funds. I don't believe that, and I don't think the majority of investors believe that. Where that comes from, I don't know.

By definition, institutional investors are sophisticated enough to understand the underlying risk and the shadow NAV takes that into account.

Mr. HURT. Thank you, Mr. Gilligan.

Mrs. WAGNER. Thank you—

Mr. HURT. The gentlelady's time has expired.

The Chair now recognizes Mr. Perlmutter for 5 minutes.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

Ms. Bair, I don't like being at odds with you. We went through all of this together 5 years ago today, I think, is when we began to see a run on money markets. And the reserve fund broke the buck today or tomorrow, 5 years ago.

So, this net asset value floating—Mr. Hurt asked a question and I want to just follow up on that—Lehman Brothers is, say, at 10 o'clock on a Sunday night, is at 20 bucks per share, and reserve has it as an asset trading; by Monday morning, it is 2 bucks a share. Okay?

So, in a time of crisis—because that week was Merrill Lynch, AIG, Lehman Brothers, Wachovia, Washington Mutual and then the money markets—in 5 days.

The net asset value piece, I don't understand how it makes a difference. Because all of a sudden, they have gone from $1.2 per value, down to 97 cents. And the net asset value is just going to tell you that.

My feeling, and I guess I am very laissez-faire on this—Colorado counties lost a ton of money in the reserve fund. They went into bankruptcy; they got 93 cents back, Okay?

What different does this make at all when you really are in a financial crisis like that? I think the insurance that—and I want to thank you for that—was posted over those couple of days, that is what stopped the run. Not the fact that people could say, "Oh geez, it is 97 cents, I want my money back."

So, please—

Ms. BAIR. So, a couple of things. We had an unstable system develop because of the stable NAV. We wouldn't have had such a large shadow banking sector; we wouldn't have had so much financial institutional reliance on money fund financing to begin with. So I think there is that.

Plus, I would like to know, why is it that we had to bail out money funds, but not other mutual funds? This was just a matter of repricing—

Mr. PERLMUTTER. Okay, and I get—this is where I disagree, because it is at $1.2 Sunday night, and at 97 the next morning; it would have have made any difference. That is what then created, in my opinion, the run—

Ms. BAIR. But there was always repricing, there was always withdrawal. There were withdrawals in lots of mutual funds. We didn't have to bail out those mutual funds. What was it that was unique about money funds that made taxpayers have to come in and take huge risks that they have—

Mr. PERLMUTTER. What is unique is they were treated as checking accounts—

Ms. BAIR. Yes.

Mr. PERLMUTTER. And so the real issue—

Ms. BAIR. They are like banking, or shadow bank—

Mr. PERLMUTTER. As if they are treated as checking accounts, should there be insurance—not do you mark-to-market every day.

Ms. BAIR. That would be another alternative. That is something Congress would have to do.

If you want this alternative to traditional banks, if you want them to have some kind of new kind of bank called the money fund that is going to have insurance, you will need to charge for that, and you probably want to have some first-loss protection like capital, the way we do at banks. Then do that, if that is what you want, I am not—

Mr. PERLMUTTER. Or it is buyer beware, and so I guess that is where I am sort of laissez-faire, because—

Ms. BAIR. —if they—

Mr. PERLMUTTER. Colorado counties took a clobbering.

Ms. BAIR. Right.

Mr. PERLMUTTER. Okay? And if Colorado counties want to continue to do this, buyer beware.

Ms. BAIR. They are—can be—would be—were a lot better if they see the value of the fund fluctuating every day. It would be a daily reminder that they are not guaranteed. The stable NAV—

Mr. PERLMUTTER. Let me speak to Mr. McCoy. You are watching these things all the time, are you not as a treasurer? You are watching the value of your investments?

Mr. MCCOY. Absolutely.

Mr. PERLMUTTER. Every day, so it is more the retail people I am worried about, and that is why an insurance fund of some type

might be beneficial because it would be like an FDIC fund, but I just don't think the marking-to-market every day, which is what the net asset value thing is all about, changes the equation.

Ms. BAIR. But they have to, if they have to sell assets for redemptions. They have to sell at the market, so that is a much more accurate reflection of what the value of this fund is worth. I would just—a lot of people have asked me, and you did just again.

What would have made the difference if we had a floating NAV? I think the better question is, what would have happened if we hadn't had a taxpayer bailout? This idea that there is only one fund that has ever broken the buck. How many funds would have broken the buck if taxpayers hadn't stepped in? And I'm sorry, Mr. Stevens, but your industry was in a bit of a panic. I was around, and you wanted that bailout, and you bought into it.

Mr. PERLMUTTER. You and I are in complete agreement.

Ms. BAIR. And I would just like to suggest—

Mr. PERLMUTTER. Had you and the Administration, and this was the Bush Administration, not stepped in, it would have crashed terribly.

Ms. BAIR. Yes. And a lot of people would have lost money.

Mr. PERLMUTTER. I don't think this rule changes that. That is my point.

Ms. BAIR. Okay.

Mr. PERLMUTTER. No, I am done. Thank you. I yield back.

Mr. HURT. Thank you, Mr. Perlmutter.

The gentleman's time has expired.

The Chair now recognizes Mr. Scott for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. I must say, this has been a very fascinating hearing, because my eyes have been opened up to something of which I have only been dimly, dimly aware. Now, from what I have been hearing, is it a fact now that what we are saying is if this SEC proposed rule requiring the floating NAV asset value to take the place of the dollar, that this would kill the prime money market, is that an accurate statement? Does everybody agree with that?

Ms. BAIR. No, I don't—

Mr. SCOTT. Mr. McCoy?

Mr. MCCOY. We figured it would have a significant impact. I would not use the word "kill." This is something that is new ground. It is untested, and so we believed it would have a significant negative impact that would be harmful, but this is untested.

Mr. SCOTT. Tell me, what would you do if you could not invest your money in a market fund at that stable $1 per share, or you could only invest in government funds? If you had that choice, where would you put your money?

Mr. MCCOY. Yes, for us, the State of Georgia, we are buying securities directly in the marketplace. We have lots of alternatives other than money market funds. Your mid and smaller-sized municipal governments have fewer alternatives and so a money market fund, for those who can legally buy private funds, is a very good alternative for them.

Most will—of the local governments would turn to the State and local government investment pools which are run as stable value by law, and so that's our issue is that if this has an unintended

consequence that would cause an impact for a local government investment pool no longer to be able to provide that service, those local governments, the smaller ones will have difficult time finding comfortable investments that would not increase their risk and reduce their liquidity.

Ms. CHANDOHA. And I would argue that individual investors have fewer choices, so if they are not going to invest in prime funds, they could invest in government funds, but the reality is at this point in time, there is not enough capacity in government funds to absorb that. We have the largest Treasury money market fund, and almost 2 years ago we closed that to new investors because there wasn't enough capacity in that. So we do think individual investors would migrate probably to bank products.

Mr. SCOTT. So what you are saying, then, is it might not kill the prime money market, but it could put it on life support. Now, let me ask you, Treasurer McCoy, to explain so the audience will know why, if it is important operationally and legally for State and local governments to be able to transact with money market funds at the $1 level, and what would be the result, for your failure to do so, how damaging would that be?

Mr. MCCOY. That is a very good question. State and local governments, and this is separate from our pension funds, dealing with operating funds, bond proceeds and trust funds, we have to preserve the public funds, and that's our primary responsibility, to protect the public funds, and invest them where they are available as they are needed, State bond proceeds as they are needed to, or bond reinvestments, to make payments to bondholders on time, the exact amount that's needed.

We have to protect funds, operating funds, teachers, others—employees' payroll. Deposits were made, we have to safeguard those funds, invest those funds. They need to be liquid when they are needed for payment.

If anything that would inhibit that would run afoul of the whole purpose of protecting the public's funds, we do have to protect the principal and provide liquidity, and that's where this would run afoul with a lot of State statutes, I know the SEC just referenced in their comments that States may need to change their statutes.

That would be a long and healthy debate for States to determine whether it would be prudent to then put local governments' money and State government money at risk because the SEC had changed their money market fund reform, or regulations, so there—we will have a lot of issues that would come up, that would impact State and local governments, and again, these are untested waters.

Mr. HURT. Thank you. Thank you, Mr. McCoy. The gentleman's time has expired. Thank you, Mr. Scott.

The Chair now recognizes the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman. Do any of you know the answer to this: Has there ever been an estimate of what the losses would have been economy-wide had the government not backstopped the money market industry in 2008?

Ms. BAIR. No. No. I don't think they have, but my guess is it would have been a lot.

Mr. FOSTER. Or more than $1 trillion, or is there any way to—

Ms. BAIR. That I don't know, but I think a lot of funds would have broken the buck. I think a lot of retail and institutional investors would have had to wait a long time to get their money back, and when they did get their money back they would have gotten a lot less. Again, as we just said earlier, some reserve fund investors still haven't been paid, so I think the results would have been quite cataclysmic, and hurt a lot of institutional—

Mr. FOSTER. Those will be the direct losses from investors who didn't get their money back. There would be a separate class of losses when the markets froze up, and business as usual would be—

Ms. BAIR. Ironically, the bailout helped the investors, but money funds still pulled back. They didn't want to lend any more, and that was why we had problems in the wholesale funding market. The source of credit that supported other financial institutions dried up, so while the bailouts protected the investors, the money funds still pulled back, and that's why we had, one of the big reasons why we had disruptions in wholesale funding markets.

Mr. STEVENS. Congressman, could I get a word in here, if you wouldn't mind, because I think you are asking perhaps the wrong question?

The issue is what would have happened to the economy if the government hadn't stepped in to try to restore order to the commercial paper markets? We were an investor in those markets. We weren't the only investor, and we weren't the only investor that pulled back. In fact, we re-entered those markets before most. So the issue is not, as I have said before—

Mr. FOSTER. You re-entered them after the government backstopped you.

Mr. STEVENS. The guarantee program was in place. That is correct, and so from a psychological point of view, that was a very dramatic moment, true. But what ensued thereafter were a series of programs that the Federal Reserve maintained in order to get the commercial paper markets starting again.

That wasn't just for our purposes; it was for all commercial paper, investors' and issuers' purposes, and that is what got the situation resolved. I think it is important, and I would like to respond to a statement, if I can do so now, about the guarantee program.

The guarantee program is not something our industry asked for. We were told it was going to be put into place. When we were told it was going to be put into place, we insisted that it be limited in time. We also insisted that it be limited in nature. In fact, the guarantee program was designed so that if a fund broke a buck, the government might pay the difference between the 99 cents and the dollar, so the exposure was intentionally limited, and in fact, we paid $1.2 billion in guarantee fees and the taxpayer never paid a penny on that guarantee.

Mr. FOSTER. Does anyone have a comment on your comment here?

Ms. BAIR. We all have our revisionist history. You know, gee yes, that's right, the government just, for the fun of it, threw money at money funds when they didn't really need to. I don't see that the money funds pulling back with its—disruption wholesale funding

markets. There were certainly other factors, but my own agency ended up having to take huge exposure guaranteeing the debt of large financial holding companies who couldn't roll their paper without some kind of government backstop, so there was quite a lot of government support thrown at this. And money funds were a significantly exacerbating factor, and I think anything besides that is revisionist history.

So, I am sorry we have to have a different perspective on this, but I was there, and I don't recall anybody objecting in the fund industry when the government decided to bail them out.

Mr. FOSTER. Okay.

If I could change the subject for a moment, Ms. Chandoha, you mentioned that retail investors don't run, which I thought was interesting. This is, to my thinking, that it was the sophisticated investors who were the ones who actually monitor the asset values who actually are the ones who are going to get their money before the gates slammed shut, or the fund gets liquidated. Is that really the situation we want to be in, and one that you think is good for your customers?

Ms. CHANDOHA. Large institutional investors can lose their money more quickly. They also hold larger portions of funds.

Mr. FOSTER. And they monitor—

Ms. CHANDOHA. So, they can have a much bigger impact very quickly. Retail investors have very small portions for the funds. And even if they do move, it has a much smaller impact.

So, there were some redemptions in retail funds, but much more muted than institutional funds.

Mr. FOSTER. Yes. And has there ever been research by independent parties as to what fraction of money market investors actually understand the risks, and the fact that it is not just like a checking account?

Ms. CHANDOHA. We certainly do a lot of education for our clients. There is a lot of disclosure about the nature of money market funds. It is a tremendous amount of detail. As I mentioned earlier, we have been voluntarily disclosing the shadow NAV's of our money funds since earlier this year. So, we do—

Mr. FOSTER. My question is, what fraction of the investors actually look at those—

Mr. HURT. The gentleman's time has expired.

Mr. FOSTER. I yield back.

Mr. HURT. But I do think that we might have an opportunity, Mr. Foster, to get back to you if you would like to stick around.

The Chair now recognizes Mr. Carney for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman, and thank you to all the panelists. This is a fascinating discussion—question and answer back and forth. And I have heard a lot of things this morning that have raised maybe more questions than they have answered.

For me, I think—Ms. Bair, at one point, you talked—you posed a question hypothetically—if we want to see a strong money market fund industry, then you might want to do that. I get the sense from some of the things that you have said, directly and maybe implied indirectly, that you think the way the money—that the money market fund industry is too large. And you refer to it in a pejorative way as a shadow banking system.

And I think I understand that, but why do you think it is too large, or is playing an inappropriate role currently?

I am a former secretary of finance at the State level. So, I was part of the cash management policy board at the State of Delaware. I understand the value for State and local governments on finance committees for nonprofit organizations. We used money market funds as cash management tools of very valuable, efficient, convenient way to do those kinds of transactions.

The implications of what you are saying is that—or this change, I think, is that people would not see that convenience. Obviously, there are tradeoffs there, and so they would migrate to the banks, I think, clearly. And maybe that is a good thing, maybe that's a bad thing.

I would like to know your view of that. I respect your opinion considerably, and I would like to know your view on that point there in terms of going from this way of doing cash management to—back to the regular banks, if you will.

Ms. BAIR. So, what is the core function of a banking system, any banking system in a developed country? It is a place where people can put their ready cash. They can access it at any time, and know it will keep stable value. To provide that peace of mind, we have regulations, we have capital requirements, we have deposit insurance, we have access to the Fed's discount window to make sure that payment processing system works, and is liquid. And that is part of it, of the banking system. That is a core piece. That is—unlike these crazy derivatives and some of the other things that large banks do that give a lot of us heartburn, this is a core function of what they should be doing, so the fact that this—

Mr. CARNEY. If I may—I have limited time, so—but over the last 20 to 25 years, all these institutions that I just talked about have been migrating away from that into what they consider—

Ms. BAIR. Well—

Mr. CARNEY. —more convenient—

Ms. BAIR. —this was facilitated by a regulatory change made by the SEC in the mid-1980s that allowed a mutual fund to basically act like a bank. And, it worked until it didn't. There have been numerous experiences where the bank has been broken, but through sponsor support, you don't see that. We would have had massive problems in 2008 if it hadn't been for government intervention.

Mr. CARNEY. But "it worked until it didn't"—we have talked about why it didn't. I was not here in the Congress at that period of time when the prime fund broke the buck. But we saw much bigger problems in the banking system. We have much larger concerns—I do—

Ms. BAIR. In the wholesale funding markets, yes. You didn't have systemic—you didn't have deposit funds. We had a seize-up in the wholesale funding markets.

AIG, Lehman Brothers, Merrill Lynch, Bear Stearns—we had a few banks that had some problems. I don't want to suggest otherwise, but those are not depository-taking institutions.

Mr. CARNEY. But your response to, if you want a strong sector—which I conclude that you don't think is the best thing—you ought to do it through some kind of capital reserve or some kind of insurance, not through—

Ms. BAIR. I think they should act like other mutual funds. I—with the floating NAV, all the other mutual funds flow through NAV. I think money funds—they are mutual funds. They should flow through NAV.

It is the structure, not the funds themselves. You have lots of good corporate citizens who are offering these funds. But the inherent regulator structure is an unstable one. This is the classic reform of undoing a bad regulation, which would—is what we got in the mid-1980s, which developed—was the foundation for developing a very, very large shadow banking sector in the sense that—

Mr. CARNEY. So, what does the floating NAV address in your view? That—

Ms. BAIR. It tells people that your money is not protected at a dollar. It is not a cash equivalent. There are assets underneath it that float in value. And if you want to redeem, they are going to have to sell those assets for you to get your money back.

So, it is honesty in accounting. And it is also, at the end, you eliminate the first mover advantage, if you have a stable NAV, when the underlying assets are not worth that dollar, the more sophisticated investors—in this case, institutional investors in 2008—they will run. They will have an affirmative obligation to run, because they can still get out for a dollar, even though that fund is now worth only 97 cents. They lock in the losses. And less sophisticated people are left behind. They are the ones ending up holding the bag.

It is a structural weakness that needs to be addressed.

Mr. CARNEY. I wish I had more time for a fuller discussion. Thank you, Mr. Chairman.

Mr. HURT. And, Mr. Carney, I think you will have that opportunity.

This has been an excellent hearing. And we certainly appreciate the indulgence of the panel. And if it suits your schedule, we would love to have you stick around just for a few more minutes. I think there are Members who would like to ask additional questions, and we will limit those to 2 minutes, if you all can—if you could bear with us.

And so, with that in mind, I will kick it to Mr. Stivers for a period of 2 minutes.

Mr. STIVERS. Thank you.

I really appreciate the indulgence of a quick second round.

I have two questions. One is for Mr. Stevens.

A lot of the panelists here seem to ignore the 2010 rule changes that changed the investment criteria for money market mutual funds, thus making them more stable.

Can you just spend maybe 30 seconds talking about why that is important when you limit what they can invest in, and how that keeps the stable net asset value a viable way to go?

Mr. STEVENS. Thank you, Congressman.

What the rules did is impose a whole set of heightened risk-limiting conditions on money market funds. And they were almost immediately tested in 2011 during the crisis in the Euro zone, and at the time of the debt ceiling controversy and the downgrade by one of the ratings agencies of U.S. Government securities.

We came through that fine in part because of the 2010 amendments.

Mr. STIVERS. Thank you. I only have a little bit of time. I also want to give Ms. Chandoha a chance.

I am kind of scratching my head with your position, because it appears to me, your position is that a floating net asset value is great, except where it affects you. You want—you like the exemption on government funds, and you happen to have the biggest government fund in the country. And you want a retail exemption, and 99 percent of your customers are retail.

So, help me understand how you sort of put that together, that you like a floating NAV, but not where it affects you. You want the exemption.

Ms. CHANDOHA. Certainly, our clients are retail investors. And, what we appreciate with the SEC's review is that they focused in on where the potential risks lie in the money fund industry.

We do believe that regulations should focus in on where the risks lie, and not necessarily be a one-size-fits-all approach.

So, that does benefit us. But we do think that retail investors did not run—they are very stable investors—and that retail investors should be segregated from institutional investors who do have the ability to run and move assets more quickly.

Mr. HURT. Thank you, Ms. Chandoha. Thank you—

Mr. STIVERS. Thank you. And thank you, Mr. Chairman. I yield back.

Mr. HURT. Thank you.

The Chair now recognizes the ranking member of this subcommittee, Mrs. Maloney, for 2 minutes.

Mrs. MALONEY. Thank you.

I would like to ask Ms. Bair and Mr. Stevens—a lot of cities, including mine, New York City, believe that they need the money market funds in order to finance their day-to-day operations. They depend on them. Do you believe a floating rate would have hurt a city's ability to finance their local projects and their local concerns?

And in the debate on the floating NAV, is that the only way to eliminate the accounting or the cliff effect that you keep talking about, Ms. Bair, or are there other ways to eliminate it that wouldn't result in such a radical restructuring of the money market industry?

Mr. Stevens and Ms. Bair?

Ms. BAIR. So, as I said before, guarantees without capital behind them make it cheaper for everybody to do business, but—and especially with implicit government support, which I think has been a factor in the money fund industry—that model works until it doesn't. It doesn't work in times of distress.

If you don't want to go to a floating NAV, the next best alternative, I think, is to require capital behind a guarantee. If funds want to guarantee a dollar, even when the assets are less than a dollar, then force them to have some capital behind that. That is the approach being used in Europe.

I think the simpler, cleaner approach is a floating NAV. And I think that you will still have funds that retain a high degree of liquidity, that invest in short-term securities. They will float slightly, but they will still float, reminding people they are not guaranteed.

So, I don't think they are going to completely go away. But if you don't want to do floating NAV, I think the best next best option is capital, which is what the Europeans are doing, basically—proposing.

Mr. STEVENS. Very quickly, tax-exempt money market funds provide about 70 percent of all short-term municipal finance in the United States. If you create the characteristics in those funds that investors are not interested in, that source of finance will disappear. And it will have a significant effect on State and local governments throughout the country.

Witness my colleague here from Georgia today, and the thousands of others—State and local government officials—whose point of view about this is very much in the SEC's records.

Mr. HURT. Thank you, Mr. Stevens.

The gentlelady's time has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch, for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

And, again, thank you for all your help today. It has been a very good hearing.

Hypothetically, if we did go to the floating NAV, it requires a daily evaluation of the underlying assets. And while we have a 10 percent requirement for—excuse me—we have a 24-hour requirement that 10 percent be redeemable within 24 hours, and then there is a—I think is a 30 percent over 7 days. You still have a very large body of assets that are less liquid.

And I am just wondering, in the past, we have had very difficult time marking-to-market some of these less liquid assets. Does anybody have a suggestion that might allow us to avoid using internal models that, in some cases, in the past—especially during a crisis moment, we come up with these, let's call them, generous valuations on the part of the asset holder that we ran into back in 2008. Is there any way we can, sort of, manage this within the floating NAV scenario?

Mr. STEVENS. Congressman, I don't think we have problems valuing these portfolios. The weighted average maturity of the instruments in the portfolio is 60 days or less. You are talking—

Mr. LYNCH. That is the average, though.

Mr. STEVENS. The—

Mr. LYNCH. I am saying—

Mr. STEVENS. —dollar-weighted average.

Mr. LYNCH. —you are going to have. I am just asking how confident can investors be that these assets have been valued properly?

Mr. STEVENS. I think, very highly confident. Our members are putting out information, filing with the SEC, about what the mark-to-market value of these portfolios is.

Mr. LYNCH. But they are using their internal models. If there is no turnover, or if there is not an active market in that asset, we don't have a—we don't have a market valuation available. So somebody has to approximate that.

And so, in the past, during a crisis period, we have had some very wacky valuations that have not held up over time.

Mr. STEVENS. Right.

Mr. LYNCH. And I am just trying to anticipate how we would avoid that.

Mr. STEVENS. These are instruments that are valued according to amortized cost. And as I said at the beginning of the hearing, it's a valuation method the Chairman of FASB talked about how it applies in the context of money market funds. I think it produces a very reliable mark-to-market price that deviates very, very little on a—

Mr. LYNCH. Thank you, Mr. Stevens.

Mr. STEVENS. —between the dollar value.

Mr. HURT. Thank you.

Ms. CHANDOHA. I would just comment that we have been producing shadow NAVs on our money funds. And we used outside pricing services to price those.

Mr. HURT. Thank you.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 2 minutes.

Mr. SCOTT. Yes, very quickly. One point we are missing in the first round was on retail funds. And I would like to get a response from Ms. Bair, Ms. Chandoha, and Mr. Stevens quickly. The proposed rule defined a retail fund as one that allows share holders to withdraw less than $1 million a day. And the retail funds would be exempt from the floating net asset value requirement in the rule.

Now, Charles Schwab has proposed that limit be raised to $5 million. And there have been others who have suggested that the retail funds be limited to investors with a Social Security number or a particular retirement plan. Can each of you just very briefly give me a comment on that, on your definition of a refund fund and what changes you might propose in that definition and why?

Ms. BAIR. I think, as I think they should all float. I think is very—one of the problems with trying to describe about retail, is very difficult to come up with a definition that can't be gamed.

And I do worry, even with a $1 million redemption daily limit, that is still a pretty big size redemption. And people like my mother in Illinois who are not going to be checking their balances everyday are going to be stuck where the people who are more sophisticated are going to be able to get out first with this first-mover advantage, which you have at the Savynap.

So I think they should all float. But if you are going to keep it to retail, make sure it is retail. And don't let a lot of sophisticated money into this fund.

Mr. SCOTT. Ms. Chandoha, you are Charles Schwab, and you recommended it, so?

Ms. CHANDOHA. Yes, we do think it makes sense to segregate retail and institutional investors because institutional investors can move more quickly. And your mother might be impacted.

We do think that there are various ways of delineating between retail and institutional investors. We made a recommendation around the $5 million redemption limit. Social Security numbers could be another method for doing that.

Mr. SCOTT. And, Mr. Stevens, you agree?

Mr. STEVENS. You and I both, as individual investors, have a Social Security number on every account. That's an easy, admin-

istrable, and very clear line between investors like you and me and a hedge fund.

Mr. SCOTT. Thank you, Mr. Stevens.

Mr. STEVENS. Thanks.

Mr. HURT. I thank the gentleman from Georgia.

I want to thank everybody on this panel for their participation. I do think this was a very good hearing. And I thank you, especially, for indulging us in a second round of questions.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Thank you. This hearing is now adjourned.

[Whereupon, at 12:28 p.m., the hearing was adjourned.]

# A P P E N D I X

September 18, 2013

Statement
of
Representative Gwen Moore
*Examining the SEC's MMF Rule Propsal*
House Financial Services Subcommittee
on
Capital Markets and Government Sponsored Enterprise

Sept 18, 2013

I appreciate the witnesses talking time to provide the committee their perspective on money market reform.

This debate is in a more constructive place than it has been.

I am very encouraged to see this re-engagement. I believe that a cooperative process between regulators and industry will yield the best results.

It is also encouraging that this debate is now happening between the primary regulator, the SEC, and industry. I support the Fed and Financial Stability Oversight Council weighing into debates, but I think that this return to "regular order" is indicative of the healthier process we are seeing.

The witness can address the specifics of the SEC proposals, but one of the proposed options, the so-called gate, I understand was used by at least one fund during the 2008 crisis with good results. I am curious to learn more about this option.

I look forward to the Q&A, as I want to gain perspective on a few questions.

If the reforms – specifically the floating NAV, which I have lingering doubts – drive clients from money funds, where will that money

ultimately end up, and will we have actually solved a problem or just created a new one?

I understand that banks have record deposits and may not want more.

Does the money end up offshore? This is a fear raised by an SEC report, but not really answered.

I also want to understand how the various proposals will impact State and local governments – both from the perspective of governments as user of money funds, but also from the standpoint that money funds buy municipal bonds, which under the proposal will be treated like corporate paper rather than Treasury notes.

We just had a debate on whether it was fair to rate municipal bonds the same corporate bonds, as the likelihood of default on an A-rated municipal bond was still far less likely than on an A-rated corporate bond.

Does it then make sense for the purposes of money funds to treat municipal bonds like corporate bonds?

Do we have clarity on the tax and accounting consequences on floating the NAV from the IRS?

Again, thank you and I look forward to hearing from our witnesses.

# The Systemic Risk Council

**"Examining the SEC's Money Market Fund Rule Proposal"**

**Testimony of Sheila C. Bair**
**Chair, Systemic Risk Council**[1]
**Former Chair of the Federal Deposit Insurance Corporation**
**Before the House Committee on Financial Services**
**Capital Markets & Government Sponsored Enterprises Subcommittee**

**September 18, 2013**

Thank you for the opportunity to appear here today to discuss much needed reforms for money market mutual funds. Strong money market fund reform is essential to protecting investors, taxpayers and the markets. It has been five years since the Reserve Primary Fund "broke the buck" triggering massive runs on money market funds, destabilizing our markets and leading to an unprecedented taxpayer guarantee of trillions of dollars in shareholder's money fund holdings. While some modest improvements have been made around the edges, money market mutual funds continue to operate with a fundamental structural weakness that can destabilize our financial markets.

The Systemic Risk Council (SRC) believes prompt and decisive action is needed to curb system risks posed by money market funds. While we commend the Securities and Exchange Commission for seeking public comment on a proposed rule, the two primary options set forth in the SEC's proposal are not sufficient to address the risks posed by money market funds. The first (limited floating NAV) option will create a host of gaming and arbitrage opportunities and the second (gates and fees option) could make matters worse. A much better approach would be to require a floating NAV for all money market mutual funds. This is the same, simple, regulatory framework that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.

**The Stable NAV is the Cause of Money Market Funds' Structural Weakness**

Money market funds are used as "cash management" products – often as bank deposit substitutes – that, like deposits, are redeemable on demand. Unlike deposits, however, they have no capital, no insurance, no access to Federal Reserve liquidity and no legal requirements that their parent companies operate as a "source of strength". While the value of their underlying assets change

[1] Systemic Risk Council: The independent non-partisan Systemic Risk Council was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This fairly reflects the consensus views of the Council, but does not bind individual members. www.systemicriskcouncil.org

with the market every day like every other mutual fund; unlike every other mutual fund, the SEC permits money market funds to price their shares at a $1.00 even when the value of the assets underlying the fund are not worth $1.00. As has been highlighted at length by the Financial Stability Oversight Council, President's Working Group on Financial Markets, SEC, and others, this special exemption creates significant structural instability that – given the enormous role played by money market funds in the global lending markets – exacerbates crises and can threaten the functioning of our financial markets. This structural weakness must be addressed head-on: either through strong capital requirements or a floating NAV. While we are pleased that the SEC took a step in this direction by proposing a floating NAV for "institutional" "prime" money funds, we are concerned that other money funds, including retail and government funds, would retain the stable NAV weakness.

**Leaving Stable NAV in Place Will Leave Retail Investors and Markets Unprotected**

Retail investors in stable NAV funds will remain at risk for bearing the costs of first-movers who will continue to have an incentive to run at the first sign of trouble. While it is true that runs during the 2008 money market fund crisis were concentrated in the institutional prime space, this does not mean other (e.g., retail) investors or investment classes were not at real risk. Institutional investors often move more quickly than retail investors and, because of the instability generated by their run in 2008, the government took quick and unprecedented action to guarantee the funds before the instability caused by their structural weakness could spread further. In the meantime, Congress has expressly prohibited the government from repeating those steps. Accordingly, a decision by the SEC to leave retail investors unprotected in stable NAV funds with large first mover advantages would be a mistake. Not only do retail investors often lack the ability to monitor fund holdings in real time and react with the speed of institutional investors, they are often the most at risk should their fund "break the buck" and be forced to halt redemptions and liquidate holdings. As was highlighted with the Reserve Primary Fund[2], investors may have to wait a very long time before being able to access all their funds. If the SEC does leave the stable NAV in place for retail investors, which I strongly believe is ill-advised, fund companies should at least be required to set aside sufficient loss absorbing capital to protect those investors (and their $1.00 NAV) in a crisis.

**Leaving the Stable NAV for "Agencies" Would Further Subsidize Debt Issued by Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the U.S. Treasury**

The stable NAV subsidizes 2a-7 eligible assets relative to similar assets that are not eligible. Under current law, part of that artificial subsidy is spread among all 2a-7 eligible issuers (which include corporations, municipalities, the federal government and government-sponsored entities). To try to address the risks posed by the stable NAV accounting fiction, over time the SEC has narrowed the 2a-7 eligible assets, concentrating this subsidy on fewer and fewer issuers (and shorter-term debt) – and the proposal would focus it even more.

[2] While the SEC made changes in 2010 to help improve problems identified in the Reserve Fund's disorderly liquidation, those reforms remain untested.

By leaving the stable NAV for institutional money market funds that invest in "agencies" ("government funds") while floating the NAV for institutional funds that invest in corporate debt ("prime funds"), institutional investors seeking the stable $1.00 will simply move their assets from prime funds to government funds, affecting the pricing for the underlying assets.

The availability of this pool of subsidized cheap, short-term funding will also provide incentives for the Treasury and the GSEs (who issue this agency paper) to borrow short instead of long (just as many other large financial institutions did during the run-up to the financial crisis). This is a perverse incentive: one that creates a potential for significant maturity mismatch and interest rate risk in the Government and the GSEs. If these entities become dependent on cheap, short-term funding – rather than stable longer-term funding, the potential for sudden contagion from a stable NAV money fund crisis grows. While we grant the SEC is not responsible for regulating the risks of the Treasury or the GSEs, this phenomenon is a direct result of the subsidy created by the SEC through the stable NAV fiction and it risks being even more concentrated now in the agency space.

It is also important to note that the SEC's proposed definition of government funds would not eliminate "break the buck" risk from these funds. Not only would the agency debt held in these funds continue to face meaningful interest rate risk (and even credit risk for some GSE issuers), the proposal would also permit these stable NAV funds to invest up to 20 percent of their portfolio in non-agency assets. Not only could this potentially mislead investors who expect government/agency funds to be entirely or almost entirely government paper – but whatever "de-risking" comes from moving the stable NAV to government/agency assets would be lost as money funds use this 20 percent "other" bucket to reach for yield. This would put that stable NAV – and the markets – at risk in a crisis (again).

**This Disjointed Approach Could Also Raise Borrowing Costs for Traditional Commercial Paper Issuers Relative to Agencies**

By allowing stable NAV to remain for institutional government funds and floating NAV for institutional prime funds, the new rules will cause significant money to flow *from* commercial paper issuers *to* agency issuers. On a relative basis, this will artificially *raise* the cost of borrowing for corporations (whose debt is in the floating NAV "institutional prime" space), and artificially subsidize borrowing by the Treasury and these government-sponsored entities (Fannie Mae, Freddie Mac and the Federal Home Loan Banks) whose debt is in the stable NAV "institutional government" space. At a time when the government should be working to *reduce* government subsidies which distort capital allocation, this approach goes in the opposite direction.

**The "Gates and Fees" Approach Could Make the Situation Worse by Moving Up the Run**

The liquidity "gates and fees" option is potentially worse than existing law as it retains the existing structural weakness of the stable NAV, but adds increased investor uncertainty about potential gating and fees. Because investors who run first can still get their $1.00 – and investors who stay could bear the losses of the first movers and the potential for delays accessing their funds and new fees – MMF investors will have an incentive to run from these products even

earlier than they do now. In addition to reports that a number of investors object to this approach and view the floating alternative as far more palatable[3], there are real risks to markets and the payment system if a number of money funds suddenly imposed gates on redemptions in a crisis. Not only would issuers face difficulty accessing the short-term markets, but households and businesses could find themselves unable to access their money fund assets to pay bills or make payrolls.

**The Proposed Enhanced Disclosures Will Help Illustrate the Structural Weaknesses in Money Market Funds But Will Not Address the Systemic Risk**

While new disclosures will help better illustrate the structural weaknesses in money market funds – the run risks caused by the stable NAV will likely be compounded by several new disclosures which will alert investors to liquidity and NAV problems in their funds, giving large first movers the opportunity to redeem (at a $1.00) and embedding larger liquidity or capital losses on remaining holders.

Even if an investor does not want to run, because they risk bearing the losses imposed by others who do – run risk remains and may be worsened. The structure of the product continues to incentivize runs – and the disclosures provide more impetus to run. <u>Because of the stable NAV, money market fund runs are rational and not self-correcting through disclosure</u>. Accordingly, these improved disclosures may help more investors understand how to game money funds by running, but they will not eliminate the structural weakness that causes runs, nor the systemic risks that can follow.

**The Best Solution is a Floating NAV for All Money Market Mutual Funds**

A floating NAV for all money market funds would not only address the core structural weakness and systemic risks posed by money funds – it would improve market functioning and fair competition by applying equally to all issuers and all investors. To the extent certain assets perform better than others, investors in those funds will profit. To the extent they perform worse, investors will take a loss. Functioning like other mutual funds, this approach does not create new run risks – nor does it result in the SEC picking winners and losers among issuers or asset classes – as the stable NAV approaches do. A floating NAV (for all funds) is the same, simple, regulatory framework that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.

**Floating NAV and "Run Risk"**

A number of reform opponents have sought to undercut the floating NAV solution as insufficient to address all possible runs, noting that investors may still move to "safety" in a crisis. While these are often rational changes in investment decisions, in this context, opponents of a floating

[3] See e.g., "Money Funds Embrace a Rule They Shunned," Andrew Ackerman, WSJ, Aug. 11, 2013. http://online.wsj.com/article/SB10001424127887323446404579006704153363792.html

NAV appear to use the term "runs" when describing what, in other traditional mutual fund (floating NAV) contexts is just a routine move and re-pricing.
The key point though is that floating funds do not cause runs – stable NAV funds do. To its credit, the proposal notes:

> The floating NAV alternative is not intended to deter redemptions that constitute rational risk management by shareholders or that reflect a general incentive to avoid loss. Instead, it is designed to increase transparency, and thus investor awareness, of money market fund risks and dis-incentivize redemption activity that can result from informed investors attempting to exploit the possibility of redeeming shares at their stable share price even if the portfolio has suffered a loss. (emphasis added).

It is true that a floating NAV would not "prohibit" investors (even en masse) from selling short-term 2(a)-7 eligible assets because of changes in the market place. Our markets are constantly re-pricing assets (often by the millisecond). If new information arises, or events occur – markets re-price and sometimes investors sell assets in bulk and at the same time. This can occur in any asset[4] – at any time. This re-pricing occurs all the time in many stocks and bonds: many of which are held by floating NAV mutual funds without destabilizing effects.

**The Stable NAV Causes & Exacerbates Runs – While the Floating NAV Does Not**

As noted at length by the SEC, President's Working Group on Financial Markets, Financial Stability Oversight Council and others, the stable NAV provides positive incentives that encourage first movers to run – and because of the $1.00, it provides little, if any, incentive not to run. If a fund's assets are worth less than a $1.00 – and you can redeem at $1.00 – the remaining shareholders are effectively paying first movers to run. This embeds permanent losses in the fund for the remaining holders. Those shareholders can then be paid back eventually by sponsor support or suffer permanent losses when the fund breaks a buck. Over the short-term, and particularly in a crisis, the potential upside for NOT running remains ONLY a $1.00. Accordingly, an investor gets a certain $1.00 if they run, but only a possible 1.00 if they stay (and it could be less and delayed through fund liquidation, gates, etc). Accordingly, investors have every incentive to run on a money market fund at the first sign of trouble.

The floating NAV by contrast does not pay people to run. If a fund's assets are worth less than $1.00 (e.g., $0.98), its price is less than $1.00 ($0.98). Accordingly, the investors' choice is between 0.98 now or the potentially upside or downside tomorrow: just like other mutual funds. Moreover, because of forward pricing, the floating NAV – unlike the stable NAV -- requires that investors bear some of the liquidity and capital costs associated with their redemptions.[5] This is a dramatic change in run dynamics. Not only does floating NAV not actively pay first movers to

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[4] Including Treasuries, government-sponsored agency debt or repos collateralized by such debt.

[5] Some money market fund reform opponents have argued that asset managers will still sell liquid assets first – giving first movers an advantage – but this argument does not undermine the fact that the floating NAV is much better than stable NAV in this regard. That same liquidity dynamic occurs in a stable NAV product now AND the stable NAV product effectively pays investors to run. The floating NAV product does not pay investors to run – and it prices in (albeit imperfectly) the liquidity and capitals cost of the redemptions.

run (the difference between the real NAV and the $1.00), it helps limit their incentives to run (through forward pricing).

**The SEC Floating NAV Rules Must Prohibit Gaming**

Given the size of the existing stable NAV market, fund companies may try to find new ways around the SEC's floating NAV rules. While we cannot guess all the possible ways, we urge the SEC to be vigilant against such efforts. Two tools used in the past have been (1) sponsor support and (2) amortized cost accounting.

<u>Prohibit Sponsor Support.</u> The Proposal notes that:

> ...money market funds' stable share price, combined with the practice of fund management companies providing financial support to money market funds when necessary may have implicitly encouraged investors to view these funds as 'risk-free' cash. However, the stability...has been due, in part, to the willingness of fund sponsors to support the stable value of the fund.

While this is true, unfortunately, it has also been due to the SEC's willingness to allow such support. While the proposal includes more disclosure of support – the final rule should expressly prohibit sponsor support. The proposal seems to view the disclosure of sponsor support as being a negative for a fund company (as if investors will penalize a fund company for supporting them). Investors, particularly in a crisis, however, view the possibility of sponsor support as a positive. Accordingly, permitting continued sponsor support – even with greater disclosure – will give investors more reason to move assets to particular funds – not less; with a potentially unfounded expectation that the sponsor will always protect them even though the sponsor has no legal obligation to do so and is not required to set aside capital to make good on that expectation.

Allowing sponsor support to continue incentivizes investment based on a fund sponsor's likelihood of support, rather than based on asset allocation decisions. This moral hazard results in an unfair advantage for funds with large sponsors (often large, complex financial institutions and bank holding companies) at the expense of funds with smaller independent sponsors. This leads to distorted markets when those expectations are met – and potentially catastrophic consequences if the expectations cannot be (as with the Reserve Fund).

The SEC should prohibit sponsor support so money market funds actually float, so investors get the real benefit – or loss – from asset allocation choices – and so investment companies compete fairly and equally with each other based on those investment choices – NOT based on the possibility that a parent company may provide support.

Investment companies are legally separate from their sponsors and should compete with each other equally. <u>If the SEC continues to permit sponsor support it must require that sponsors put money market funds on their balance sheet.</u>

As we learned with SIVs during the financial crisis, off-balance sheet vehicles should only be off-balance sheet if their risks cannot come back even during a crisis. Investors (and regulators)

need full information about these public companies, their balance sheets and their potential future exposure – including whether they might be called upon to support a multi-billion dollar money market fund.

Amortized Cost Accounting. The proposal would also continue to allow money funds to use amortized cost for debt instruments that have 60 days or less to maturity. While we understand this exemption is limited, the SEC should make sure that this exception is not abused or gamed by clarifying that this approach only works if it accurately reflects the value of the portfolio overall – not just asset by asset.

Unlike traditional mutual funds, 60-day paper could represent a relatively large percentage of a money fund's assets (and theoretically a fund company could game the entire rule by only investing in 60 day paper) – and even "small" differences in asset by asset pricing (on an amortized cost basis vs. a mark-to-market basis) could result in a meaningful difference in a fund's value overall – particularly in a more normalized interest rate environment. Investor behavior is based on fund valuation overall not the price of individual fund assets. If investors can run at the amortized cost $1.00 – rather than the lower real mark-to-market value – they can still game the fund, embed losses on others and risk sudden drops in price and rising redemptions.

**Conclusion**

We have strongly urged the SEC to require a floating NAV for all money market mutual funds – and I would encourage Members of the Committee to do so as well. As seen during the 2008 crisis, the rigidity and destabilizing effects of a stable NAV can shut down capital formation for issuers who rely on money market funds for short-term funding. A floating NAV would make markets much more flexible and allow funds – and markets to remain open and functioning in a crisis. Moreover, while other crises are sure to occur, they would no longer be caused or exacerbated by the stable NAV. Finally, a strong floating NAV approach, as outlined here, would help level the playing field for investment companies and investors by helping ensure that investment decisions and competitive outcomes are based on the quality of asset allocation decisions not the moral hazard of potential sponsor support. This is the same, simple, regulatory framework that applies to all other mutual funds: a framework that the SEC has implemented successfully (and without systemic risk or taxpayer bailouts) since 1940.

**Written Statement of Marie Chandoha**
**President and Chief Executive Officer,**
**Charles Schwab Investment Management, Inc.**
**Before the US House of Representatives Committee on Financial Services,**
**Subcommittee on Capital Markets and Government-Sponsored Enterprises**

**"Examining the SEC's Money Market Fund Rule Proposal"**

**September 18, 2013**

Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee, my name is Marie Chandoha, and I am the president and chief executive officer of Charles Schwab Investment Management, Inc., the asset management business of the Charles Schwab Corporation. Thank you very much for the opportunity to be here today to discuss Schwab's perspective on the SEC's money market fund proposal.

Schwab is one of the largest managers of money market fund assets in the United States, with 3 million money market fund accounts and $168 billion in assets under management as of June 30, 2013. The overwhelming majority of Schwab's fund offerings are used by retail investors who use money market funds to manage their cash. Approximately 88% of Schwab's money market fund assets are in sweep funds, with the balance in purchased funds. Sweep accounts automatically invest idle cash balances while providing investors with convenience, liquidity and yield. These sweep accounts facilitate trading in brokerage accounts, allowing individuals to seamlessly buy and sell stocks, bonds, and mutual funds. Individuals also can write checks, pay bills electronically and use debit cards on these accounts. Even in the current environment, with historically-low yields on money market funds, our retail clients continue to value the convenience of this product.

**Overview of Our Position**

We generally support the SEC's reform proposal because it strikes the right balance between reducing the likelihood of runs while also preserving money market funds as an extremely important cash management tool for individual investors. At the same time, we believe the proposed rule has a number of significant areas that need resolution before the rule is finalized. We believe a careful cost benefit analysis regarding the cost of implementation and the impact on the larger financial system, should be undertaken.

To maximize the impact of the proposal, Schwab recommends that the final rule combine the two alternatives proposed, subject to the recommended changes outlined below, for maximum effectiveness: requiring institutional prime funds to have a floating net asset value (NAV), and allowing a fund's board to impose liquidity fees and gating of all prime, municipal and government money market funds whenever the board believes doing so is in the best interest of the fund.

In our comment letter to the SEC[1], we offer a number of recommendations in an attempt to strengthen the proposal. An overview of our key recommendations follows:

1. We recommend that the daily redemption limit for retail investors, which serves as the dividing line between "institutional investors" and "retail investors," be increased from $1 million to $5 million per business day. We also recommend that the Commission create a "Large Trade Order Notification" system that would allow retail investors to redeem more than the maximum daily redemption amount provided they have requested and received approval from the fund for such a transaction at least three days in advance.

2. We recommend that municipal (tax-exempt) money market funds be exempted from the floating NAV proposal.

3. We request that the rule confirm the treatment of registered investment advisers in the context of the definition of "retail" and "institutional" investor.

4. We recommend that retirement accounts (Individual Retirement Accounts and employer-sponsored 401(k) and similar plans) and educational accounts such as 529 plans be exempted from the rule.

5. We recommend that the tax issues identified by the Commission in its proposal be resolved by the appropriate regulator prior to the rule taking effect.

6. While generally supporting the Commission's proposed enhancements to disclosure, Schwab has a number of recommendations for changes.

**Alternative One – Floating NAV for Institutional Prime Funds**

In its proposal, the Commission calls for requiring certain institutional prime money market funds to move from a stable NAV to a floating NAV, while permitting retail prime money market funds, Treasury money market funds and Government money market funds to retain their stable $1-per-share price. Schwab has long opposed a broad floating NAV for all money market funds as a lethal blow to the product. We believe that what limited risk there is of a run in a money market fund lies with institutional investors. Chairman White articulated this view concisely in her opening statement at the Commission's Open Meeting at which it voted unanimously to propose the rule: "This floating NAV proposal specifically targets the funds where the problems during the financial crisis occurred: institutional, prime money market funds."[2]

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[1] Comment letter from Marie A. Chandoha, Charles Schwab Investment Management, Inc. (the "Schwab comment letter"), to SEC proposed rule, "Money Market Fund Reform: Amendments to Form PF," File No. S7-03-13, 78 Federal Register at 36834, June 19, 2013. Available at: http://www.sec.gov/comments/s7-03-13/s70313-109.pdf.
[2] White, Mary Jo, "Opening Statement at the SEC Open Meeting," June 5, 2013. Available at: http://www.sec.gov/News/Speech/Detail/Speech/1365171575546#.UhFnBz_ZPDY.

While we continue to oppose a broadly-applied floating NAV for the entire money market fund industry, we believe a targeted solution such as the one put forward by the Commission would make the product less susceptible to destabilizing runs yet preserve this critically important product for retail investors. A floating NAV would reduce the "first-mover advantage." Runs in money market funds can be triggered when institutional investors who have the ability to redeem large amounts of shares believe that a fund may be in danger of seeing its share price fall below $1 per share and they redeem their shares. There is an incentive to be first to redeem because investors who are slower to redeem have a higher chance of getting less than $1 per share return on their investment if the fund's share price does "break the buck." We agree with the Commission's assessment that a floating NAV would reduce the incentive to redeem shares and would result in greater appreciation of the risks in money market funds by making gains and losses more apparent to investors.

Where the Commission once appeared to have an unrealistic goal in mind for money market fund reform – namely, eliminating any possibility of a run – there is now an acknowledgement that such a goal is impossible. No regulatory solution short of banning an entire product can eliminate the risk of a run, and the floating NAV is no perfect panacea. If a crisis is bad enough, investors in a floating NAV fund will run, even at the risk of getting less than $1 per share return. But the targeted floating NAV proposal the Commission has put forward accomplishes the critical goals: reducing the risk of a run and reducing the impact such a run would have on retail investors.

**Distinguishing Between "Retail" and "Institutional" Investors**

We believe the proposed $1 million Redemption Limit for distinguishing between "retail" and "institutional" investors is too low and we recommend that the limit be increased to $5 million. Our concern is for operational complexities and the negative client experience that will result if the limit is set too low. If the client experience is poor or has complexities, clients will move out of retail prime funds in large numbers. Prime retail money market funds with a daily redemption limit need to maintain most of the value proposition of today's money fund or clients will abandon the product. At a threshold of $5 million, this value proposition for retail investors can be better maintained, yet this threshold is still low enough that it would not include institutional investors.

There are numerous circumstances in which a retail investor might find himself needing to move more than $1 million out of money market fund in a single day. The Commission's proposal notes some: "a retail investor may make large redemption requests when closing out their account, rebalancing their investment portfolio, paying their tax bills, or making a large purchase such as the down payment on a house."[3] To that list, we would add other examples, including the sale or purchase of a small business and the transfer of assets from one firm to another.

The example of transferring assets from one firm to another is a useful illustration of how cumbersome the rule could be for clients. A client with a $50 million portfolio, including $5 million in a prime money market fund, decides to transfer that portfolio from Financial Services Company X to Schwab. Under the current proposal, the client could only sell out of his position

[3] 78 Fed. Reg. at 36859.

in the prime money market fund in $1 million increments, a process that would take 5 business days. That cash would then be transferred to Schwab, where we would sweep that cash into a money market fund that night. If the cash was swept into a prime fund, the new client would not be able to diversify right away; rather, he would again be limited to $1 million daily redemptions in order to then purchase shares of a stock, bond, mutual fund or other investment product. This kind of client experience is simply untenable. To avoid such a scenario, Schwab would undoubtedly prohibit the incoming cash from being swept into a prime money market fund and would instead sweep the cash into a Treasury or government money market fund, potentially at a lower yield.

Schwab's heavy use of money market funds as the sweep vehicle presents a host of other challenges. Given that a client can use a variety of mechanisms to access the funds in his sweep account, including writing a check, withdrawing cash at an automatic teller machine, and using a debit card to make a purchase, it is not clear how a client whose aggregated activities exceed the redemption limit during a given day should be treated. For example, if a client with $1.5 million in prime money market fund assets makes an online purchase of $995,000 worth of shares in a stock, and on the same day his $10,000 donation check to his alma mater clears, he pays three bills totaling $750 via electronic bill payment, and withdraws $100 in cash at an ATM, he has exceeded the daily redemption limit by $5,850. Schwab will be required to reject certain of these client transactions to ensure compliance with the daily dollar threshold, resulting in an unsatisfactory client experience and likely negative external impacts to the client that derive from the canceled cash transactions. Moreover, a client will have to self-monitor his cumulative money fund withdrawals for a given day, which could be overwhelmingly complicated as it could include pending withdrawals from previous days' activity, the clearing of previously written checks, and the settlement of executed trades across all of the shareholder's accounts.

**Need for a "Large Trade Order Notification" System**

Schwab strongly supports the addition of a mechanism for retail investors to redeem more than $1 million (or more than whatever daily redemption limit the Commission ultimately settles upon in the final rule) in a single day, provided the investor gives advance notice of their intent to do so. We call this a "Large Trade Order Notification" system, or LTON. We believe this is an important addition to the rule because it benefits retail investors and will help alleviate investor anxiety when an unusual circumstance arises – a house sale, a small business sale, a transfer of assets from one firm to another, or other event that warrants a significant movement of cash in and out of a money market fund – while also allowing the fund manager enough time to prepare for the larger-than-usual redemption without affecting the fund or other investors.

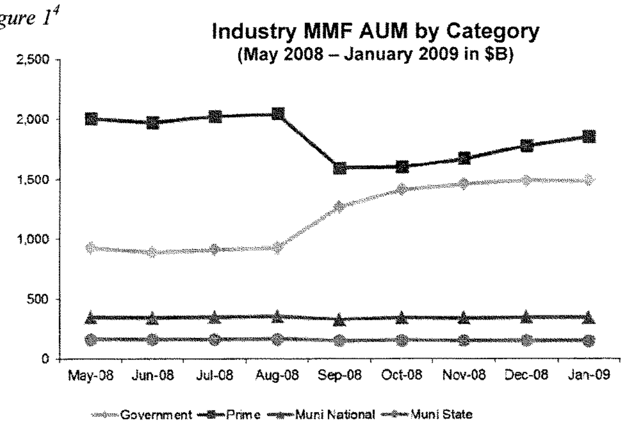
We recommend that the Commission adopt an LTON that requires the investor to provide the fund with information about his or her intention to redeem in excess of the daily redemption limit, including the amount of the redemption and the date of the redemption, with a minimum of three business days advance notice. We believe that there should be no limit on the amount of the redemption, but that the fund manager should be granted the discretion to reject all or part of the redemption request if the request is so large as to potentially put the fund at an inappropriate level of risk. For example, a fund manager could decide to decline a redemption request if it would cause the fund to fall below the required 30% weekly liquidity level under Rule 2a-7 or

otherwise have an adverse impact on the fund. We suggest giving the fund manager broad discretion on this point.

**Exception for Municipal (Tax-Exempt) Money Market Funds**

Schwab believes strongly that municipal (tax-exempt) money market funds should be exempted from the floating NAV requirement. A key reason to exempt tax-exempt money market funds from the proposal is that these funds are much more liquid than prime funds and are significantly less susceptible to runs. An examination of the performance of municipal money market funds during the 2008 financial crisis underscores this point. As seen in Figure 1, municipal money market funds – both national funds and state-specific funds – were remarkably stable during the financial crisis, particularly when compared with prime funds.

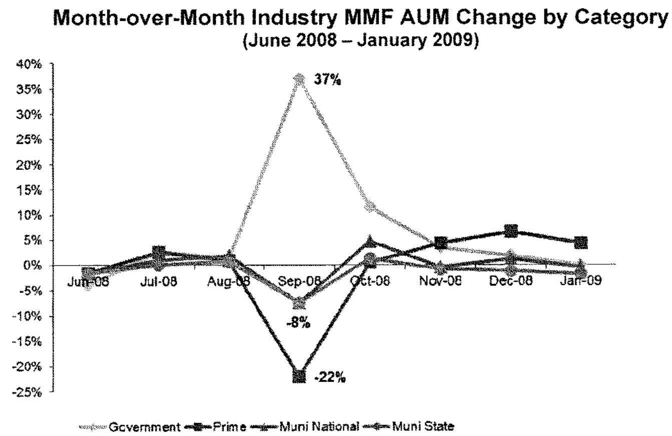
*Figure 1*[4]




In Figure 2, which shows the month-over-month change in assets under management in different types of funds from June 2008 through January 2009, we can see that during the worst month of the crisis – September 2008 – municipal money market funds dropped only 8% industrywide, as compared to a 22% drop in assets in prime funds.

[4] Data for Figures 1 and 2 compiled using end-of-month assets under management data from iMoneyNet (www.iMoneyNet.com)

*Figure 2*




The experience with Schwab's proprietary municipal money market funds during the crisis shows that these funds are particularly resilient. Schwab's largest tax-exempt fund is the nationally-diversified Schwab Municipal Money Fund Portfolio, which in August 2008 accounted for nearly half of all municipal money market fund assets under management at Schwab. Between August 2008 and December 2008, the largest weekly outflow the fund experienced was 5.1% of assets – far below the minimum weekly liquidity requirement of 30%. Only one of Schwab's eight municipal money market funds experienced an outflow of greater than 10% in any week during the crisis, still well below the weekly liquidity requirement. Indeed, Schwab's municipal money market funds typically hold much more than the required 30% in weekly liquidity; for the first seven months of 2013, Schwab's Municipal Money Fund (SWXXX) held weekly liquid assets ranging from 68% to 72% of total assets.

Another compelling reason to exempt tax-exempt money market funds from the proposed reforms is that the product as a whole does not pose a systemic risk. Municipal money market funds comprise just over 10% of total money market fund assets -- $267.06 billion out of a total of $2.622 trillion as of August 14, 2013.[5] Despite its relatively small size, the municipal money market is critically important to the financing of state and local governments because the money fund industry is the largest investor in short-term municipal securities. We do not believe that a product of this size, yet with outsized importance to the economy, warrants the complex and costly operational challenges that would be presented by trying to comply with the daily redemption limit envisioned by the Commission's proposal. We urge the Commission not to rely on the current rule proposal's assumption that most tax-exempt funds would qualify for the retail money market fund exception to the floating NAV, and instead specifically exempt municipal money market funds from the proposal.

[5] "Money Market Mutual Fund Assets," a weekly report compiled by the Investment Company Institute, August 15, 2013. Available at: http://www.ici.org/research/stats/mmf/mm_08_15_13.

**Treatment of Registered Investment Advisers (RIAs)**

The Charles Schwab Corporation's Advisor Services business provides trading, custody, technology, practice management and other support services to nearly 7,000 registered investment advisers. Registered investment advisors are not shareholders of record, and thus, by the terms of the proposed rule the Redemption Limit would not and should not apply; rather, the proposed rule would require that the Redemption Limit be applied to the investment adviser's underlying clients, either by the financial intermediary that custodies the underlying clients' assets or the investment adviser itself. Registered investment advisers typically bundle the transactions of their many retail clients into a single transaction, much in the same way that a financial intermediary holding an omnibus account bundles trades of its underlying customers. A registered investment advisor, however, is not an "omnibus account holder" as defined under the proposed rule.

We do not believe it is or should be the Commission's intent to apply the Redemption Limit to registered investment advisers. Retail investors who choose to engage the services of a registered investment adviser should not be excluded from retail funds in which they otherwise would be permitted to invest. Indeed, if registered investment advisers are subject to the redemption limit, it would be penalizing the retail client who has elected to outsource their investment management to a professional rather than handle it themselves. We are concerned, however, that because the proposed rule does not expressly consider the treatment of registered investment advisers, there could be a lack of clarity as to its application relative to these advisers. As such, we respectfully ask that the Commission confirm our understanding of the proposed rule as it relates to registered investment advisers.

**Tax Treatment of Floating NAV Money Market Funds**

We share the widely-held view that the tax implications of moving to a floating NAV are significant and need to be resolved *before* the rule takes effect. Shareholders in a floating NAV fund would experience small gains or losses on the sale of their shares and would be required to track those gains and losses for determining their tax burden. Given that clients may make hundreds of transactions within a money market fund every year, the burden on tracking this information seems wildly out of proportion with the potential revenue gain for the Treasury.

We applaud the efforts of the Commission to work with the Department of the Treasury and the Internal Revenue Service on this issue. Earlier this year, the Treasury Department issued a proposed Revenue Procedure[6] that addresses one aspect of the tax implications for a floating NAV fund – the wash sale rule. The proposal includes a *de minimis* exception from the loss disallowance rule if the loss is less than 0.5% of the taxpayer's basis. While we support this proposal, we note that it does not eliminate the requirement to track compliance with the wash sale rule. We recommend that the IRS simply exempt floating NAV money market funds from the wash sales reporting rules.

With regard to the reporting of gains and losses, some of the issues could be ameliorated if the

[6] "Application of Wash Sale Rules to Money Market Fund Shares," Internal Revenue Service Notice 2013-48. Available at: http://www.irs.gov/pub/irs-drop/n-13-48.pdf.

IRS were to issue guidance allowing net information reporting by funds and summary income reporting by shareholders. But, again, these steps do not relieve funds of the burden of tracking literally hundreds of thousands of transactions per day and reporting gains and losses to investors. At Schwab, between March 16, 2013, and June 25, 2013, we conducted an average of 365,000 sweep transactions per day, with a peak day of 1.1 million sweep transactions. The burden of tracking and reporting the gains and losses within each of those transactions presents a systems issue that would be prohibitively expensive to develop and implement.

To illustrate the *de minimis* gains and losses at stake, we analyzed our largest money market fund, the Cash Reserves Fund (SWSXX) to estimate the net gain or loss realized by shareholders who redeemed during a particular period. Since Schwab began calculating daily mark-to-market NAV of the fund in March 2013, there has been little price fluctuation. Between March 25, 2013, and July 23, 2013, the range of the daily NAV of this fund spanned $1.000132 to $1.000179. With that narrow of a fluctuation, the daily gains and losses offset one another, resulting in a negligible gain over the time period. As of July 23, 2013, the fund had more than $37 billion in assets and more than 700,000 investors. That infinitesimal gain is spread out among each of those investors. In other words, on a per-investor basis, the net gain was a fraction of a penny – an amount that could not be remitted to the Treasury anyway.

Given the operational burdens of tracking and reporting this information and the negligible impact to the Treasury in terms of revenue, we urge the Commission to continue working with the IRS to eliminate this tracking altogether unless the gain or loss on any transaction exceeds 50 basis points.

**Alternative Two – Standby Liquidity Fees and Gates**

The Commission proposes, as an alternative to the floating NAV for institutional prime money market funds, imposing two provisions for money market funds that encounter distress. Funds would be allowed to continue to transact at a stable, $1-per-share price under normal conditions, but when the weekly liquid assets of a non-government money market fund drop below 15% of the total assets, the fund would be *required* to institute a liquidity fee and would be *permitted* to impose a redemption gate.

Schwab's recommendation is that the Commission should permit the fund's board to impose either a liquidity fee or redemption gates whenever it determines that doing so is in the best interest of the fund and its shareholders. Instead of having the 15% weekly liquidity level as the trigger for an imposition of fees and/or gates, the proposal should require the fund's board to meet when the fund's weekly liquidity hits 15%, if it has not already done so. The fund must then issue a public statement from the board indicating that it has met as required, that it has determined that redemption gates and/or liquidity fees are to be imposed or not imposed, and its reasons for the decision it has made.

We believe that gating and redemption fees can be a powerful tool if a fund is under serious stress and heading towards liquidation. In such a scenario, these tools would help facilitate an orderly liquidation and ensure that shareholders are treated fairly, as there would be less opportunity for first mover advantage. We believe that this is the only circumstance in which it

would be reasonable to impose gates and/or fees, as we have a hard time seeing how any fund that actually imposed fees and or redemption gates would ever be able to recover and be a viable fund again. Investor trust in that fund would be lost. We see the fees and gating proposal, then, as an interim step toward orderly liquidation of a fund.

We also believe that the board should have more discretion over when to impose gates and/or fees, rather than having a mandatory trigger of reaching 15% weekly liquidity. There are situations in which a fund could be under stress without reaching the proposed trigger point. For instance, the liquidity of a fund could be high, but a default of a creditor in the portfolio could put the fund in a highly-stressed scenario. In such a situation, the board might believe it is in the best interest of the shareholders to gate the fund and impose liquidity fees. It should have the ability to do so.

Moreover, a hard trigger could lead to "pre-emptive" runs on funds as they approach the weekly liquidity threshold. With the increased transparency of money market funds, investors can keep close track of a fund's weekly liquidity levels. Sophisticated investors will likely redeem from the fund as it approaches the 15% weekly liquidity trigger, though it is not clear at what point they will begin redeeming – it could be 20%, or 18%, or some other number. The result could be a run that sends the fund more rapidly below the trigger point, from which we have already asserted the likelihood of recovery is minimal. By giving the board discretion to impose fees and/or gates at any time, this risk is mitigated. Moreover, since there is no certain point at which fees or gates must be imposed, it lessens the likelihood of a run.

We agree with the Commission that liquidity fees would add an important disincentive to early redeemers. As discussed earlier, a key concern of the Commission is that early redeemers have an advantage over other investors when a fund is under stress, since they will get a full return on their investment and later redeemers may not. A liquidity fee would force early redeemers to pay for the costs of their redemption, without knowing whether the fund was actually going to experience losses or not. This is a powerful disincentive.

While we agree that the proposed liquidity fee of 2% would be a strong disincentive to redeem during a crisis, we also support the provision in the rule proposal to allow the fund board to increase or decrease this fee if it determines that circumstances warrant such action. The latter provision gives the board needed flexibility.

We also note that there are several operational challenges, particularly for sweep funds, that arise with the possibility of fees and/or gating, which further supports providing the board discretion to impose fees and gates rather than subjecting funds to a hard trigger. As envisioned by the Commission, once a fund imposes a liquidity fee, that fee would be taken out of each client transaction. However, at Schwab, our money market fund sweep clients are able to use debit cards, make withdrawals of cash at automatic teller machines, write checks, and use electronic bill pay to access their money market fund assets.

If a mandated liquidity fee is imposed on a fund during the course of the day, and the client makes a series of transactions that day, we would have to impose the liquidity fee on each transaction retroactively. For example, if the client writes a check tied to his or her sweep fund

holdings to make a $100 purchase at the grocery store and uses a debit card to buy a $4 cup of coffee at Starbucks, at the end of the day Schwab would have to impose a $2.08 liquidity fee on those transactions. The funds could be withdrawn from the client's remaining balance in the fund and the client notified of the fee, but this would be a cumbersome and time-consuming process. Alternatively, Schwab could bounce the check, which could potentially trigger additional fees, not to mention frustrate the client.

The Commission notes in its proposal that it chose to require the fee, rather than make it fully discretionary, because of concerns that "a purely discretionary trigger creates the risk that a fund board may be reluctant to impose restrictions, even when they would benefit the fund and the short-term financing markets."[7] We believe that this view does not take into account that fund boards have a fiduciary duty to act in the best interest of the fund's shareholders. As noted above, imposing fees or gates is, in our view, tantamount to commencing an orderly liquidation of the fund. But not every instance of a drop in weekly liquidity will warrant such drastic action. We urge the Commission to empower fund boards to impose liquidity fees and/or redemption gates whenever it believes doing so is in the best interest of the fund, and to require the board to meet and determine whether or not fees and/or gates are warranted if the fund hits 15% weekly liquidity and the board has not already taken any action.

**Exemption for Retirement and Education Accounts**

We believe that retirement and education accounts should either be allowed unlimited redemptions, or, perhaps more simply, exempted entirely from both alternatives in the proposal. Accounts such as Individual Retirement Accounts ("IRAs"), employer-sponsored defined contribution retirement plans (such as 401(k) plans and 403(b) plans), and 529 college savings plans are designed for individuals and serve no purpose for institutional investors. We believe the risks in these types of accounts are minimal.

Defined contribution plan sponsors often select money market funds as a capital preservation fund investment alternative. In virtually all plans, this is the only stable NAV investment option. Some plans even <u>require</u> a stable NAV investment option within the capital preservation category. A floating NAV money market fund is likely to be unworkable as an investment option in a defined contribution plan.

The major issues for these accounts, however, arise with the Commission's Alternative Two, which contemplates imposing liquidity fees and redemption gates in certain circumstances. The proposal has a number of unintended consequences for retirement plan participants and sponsors. For example, the proposal may inadvertently cause a plan participant to violate the Minimum Required Distribution rules. Participants in qualified retirement plans and Individual Retirement Accounts generally must begin receiving distributions by April 1 following the year in which the participant or IRA holder reaches age 70 ½. Failure to make the distribution may result in disqualification for the retirement plan or IRA and excise taxes for the participant or IRA holder. The imposition of a redemption gate may cause the plan or the IRA to fail to make a timely distribution if all or some of the assets from which the distribution needs to be taken are held in a money market fund that has a gate in place.

[7] 78 Fed. Reg. at 36884.

In our comment letter to the SEC, we outline several other common situations in which potential unintended consequences could impact a plan participant. Similar complexities arise in education accounts, such as 529 plans. We believe that many plan sponsors would avoid these issues by simply declining to use any money market fund that has even the potential of being subject to liquidity fees and/or redemption gates. A movement by retirement plans away from prime money market funds and into money market funds not subject to the proposed rules, such as Treasury or government funds, would further exacerbate the concentration within those types of funds. If plan sponsors did not believe that such funds were adequate for the plan's needs, it could increase desire for other types of stable-value products, in an environment where the supply of such funds is diminishing. In addition, a plan sponsor's selection of a government money market fund as the cash sweep vehicle for a plan would not necessarily be the most appropriate vehicle for retirement plan assets that are already tax-exempt while held in the plan's trust.

As a result of the complexities that arise in the context of an employer-sponsored plan, IRA or an education account, we recommend that these types of accounts be exempted from both alternatives in the Commission's proposed reforms.

**Combining Alternative One and Two**

Schwab supports combining the two alternatives proposed by the Commission – with the recommended changes outlined in this letter – into a single final rule because the two alternatives together provide a larger set of tools to deter runs in money market funds. The first alternative applies only to institutional prime money market funds. The second alternative, the liquidity and gating proposal, would be available as an option, should the fund board determine it is necessary, to prime, municipal and government money market funds. Together, we believe the two alternatives cover a broader array of products and could prove effective at deterring destabilizing runs.

**Enhanced Disclosure Requirements**

Generally, Schwab believes that more disclosure and transparency is better for individual investors. Of course, all regulators struggle with achieving an appropriate balance between providing the right amount of information to investors to help them make informed investing decisions and overwhelming investors with so much disclosure that they do not read or absorb any of it. It is Schwab's view that the Commission's call for enhanced disclosure has, for the most part, achieved the proper balance, with the exception of some elements of the rule proposal where we believe that the cost and complexity of producing the information far outweighs the benefits to investors or to the Commission. Proposed disclosures around instances of sponsor support would provide investors with useful context for analyzing the stability of the fund, though we would note that not all instances of sponsor support are indicative of a fund under even mild stress, let alone nearing the point of breaking the buck. Requiring daily disclosure of a fund's current net asset value, which Schwab began voluntarily making available in February 2013, would be a very valuable tool for investors.

There are elements of the proposed disclosure requirements, however, that we believe are not appropriate. In our comment letter, we recommend that the SEC eliminate the requirement to provide new, detailed information with respect to every portfolio holding – a costly process that we do not believe would result in useful information for investors. We also believe that disclosing the total percentage of shares held by the 20 largest shareholders of record could lead to misperceptions of the concentration risk in a fund, since a financial intermediary could be reported as a significant holder of fund shares despite the fact that no one underlying investor has any meaningful number of shares. There are also several examples of disclosure requirements in which the proposed time period for making the information available is simply unrealistic.

**Cost Analysis of Complying with the Proposed Rule**

As required by law, the Commission has included in its proposed reforms an analysis of the costs of compliance. We find the Commission's conclusions to significantly underestimate those costs. In some areas, the Commission's estimates are low by multiple orders of magnitude. We cite below some representative examples of the anticipated costs of the proposed reforms.

One area in which we believe the Commission has not adequately considered the cost of its proposal is in the development of a floating NAV institutional prime money market fund. The Commission staff's estimate for the systems modifications necessary to support a floating NAV money market fund in the proposal ranges from $1.2 million to $2.3 million.[8] By contrast, given the complexities of developing the operational capability to support our sweep features, we estimate that the one-time cost will exceed $10 million.

We also believe that the Commission has not adequately considered the costs of educating and training employees to understand the new rules, or the costs of communicating the rule changes to clients. We estimate these costs to be in a range of at least $4 million in advance of the new rules taking effect, and at least $500,000 in annual costs thereafter. The Commission's proposal does not include a specific estimate of education, training and client communication costs. Rather, the proposal embeds these costs as part of its estimates of the costs of developing the systems to support floating NAV funds, daily redemption limits, gates and fees, and other aspects of the proposal. We believe this leads to a serious underestimation of the communications and education challenges that funds will face if these rules were to be approved.

**Potential Repercussions of Money Market Fund Reform**

While Schwab generally supports the SEC's reform efforts, especially in the context of other proposals that have been considered, the reforms being proposed would bring about fundamental changes to money market funds, at significant cost. Those changes have potentially significant repercussions on the larger financial system that warrant careful consideration by the Commission. Among the most significant is the degree to which the proposal would reduce the number and size of prime money market funds by driving those assets elsewhere.

The question then becomes what is the impact on other products if prime money market funds experience a sharp decline in assets. In particular, we believe the impact on government money

[8] 78 Fed. Reg. at 36871.

market funds will be significant. Government money market funds would undoubtedly absorb the majority of the assets that move out of prime money market funds if a daily redemption limit were to be imposed on the latter. But it is not clear that government money market funds have the capacity to handle this amount of inflows. Portfolio managers of government money market funds would likely find themselves in a frantic competition to purchase a dwindling supply of securities. The combination of tight supply, high demand and low interest rates will continue to put pressure on government funds. It will become increasingly challenging for these funds to maintain a positive rate of return for investors.

Alternatively, assets could flow to other types of products, such as bank products or ultra-short funds and exchanged-traded funds. None of these products are regulated by Rule 2a-7. Many of the largest banks are likely to be reluctant to absorb these dollars because of the impact on their capital ratios, the lack of short-term investment options, and the fact that they must pay deposit insurance based on their assets.

Another potential concern is that the transition to a new regulatory regime for money market funds could itself spark a destabilizing run of the very kind the rules are intended to prevent. We expect that, if the Commission finalizes a rule calling for institutional prime funds to have a floating NAV, there will be a quick exodus by institutional investors from prime funds to government funds or other products that do not have the new restrictions. This could lead to worry by other investors that the large redemptions are either indicative of a problem in the fund or will lead to liquidity concerns within the fund as it seeks to meet those redemptions – and those investors could then also seek to redeem.

We believe it is incumbent upon the Commission to carefully weigh these potential impacts on the broader financial system as it considers a final rule.

**Conclusion**

The SEC has proposed a serious set of reforms that will have enormous ramifications on the money market fund industry. They will be costly for Schwab and other firms to implement, and they represent a fundamental overhaul of a product investors of all types have relied upon for four decades. But we support the proposed reforms because they target the reform where the risk exists and reform will have its greatest impact: institutional prime funds. By exempting retail investors from the floating NAV, the Commission is acknowledging both that the product is of critical importance to retail investors and that these investors are not likely to cause a run. We believe that this proposal, when combined with increasing the ability of fund boards to impose redemption gates and/or liquidity fees to facilitate orderly liquidation of a distressed fund, will produce a stronger, more robust money market fund industry. Other regulators have called for a one-size-fits-all approach that would destroy the product for individual investors. We believe the SEC has found a tough yet pragmatic solution that will boost investor confidence, deter destabilizing runs, and ensure that individual investors can rely on this critically important product for generations to come.

Thank you very much for the opportunity to offer Schwab's perspective on this important issue. I would be happy to respond to any questions.

# Statement of the U.S. Chamber of Commerce

**ON:** "SEC Proposal on Money Market Funds"

**TO:** U.S. House of Representatives Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises

**BY:** James P. Gilligan

**DATE:** September 18, 2013

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Good morning Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee. Thank you for the opportunity to discuss the potential impact of the Securities and Exchange Commission's (SEC) proposal regarding money market mutual funds (MMMFs) on the business community.

My name is James Gilligan, and I am the Assistant Treasurer of Great Plains Energy Incorporated. Great Plains Energy is the holding company of Kansas City Power & Light Company and KCP&L Greater Missouri Operations Company. These utilities operate under the brand name KCP&L. Our electric utilities serve over 830,000 customers in 47 counties in Missouri and Kansas with a combined diverse generation platform of more than 6,600 MW of capacity. I am also a former member of the Board of Directors for the Association for Financial Professionals (AFP) and currently serve as the Chairman of its Government Relations Committee. AFP's membership includes more than 16,000 financial professionals employed by over 5,000 companies and organizations. I am here testifying on behalf of the U.S. Chamber of Commerce and the thousands of corporate treasury officials and financial professionals who are tasked with managing their companies' cash flows and ensuring that they have the working capital and liquidity necessary to efficiently support their operations.

**Key Points**

There are several important points I wish to stress to the Subcommittee.

- At the outset, we must be mindful that with respect to money market mutual funds, the SEC is not operating in a vacuum. MMMFs have existed for over four decades. These funds are used by businesses throughout the United States to meet their cash management and short-term funding needs. They are an integral part of a tightly interwoven system for low-cost, short-term business financing of unrivalled liquidity and efficiency. This system has served the American economy well, and provides a competitive advantage for American businesses in global markets.

- The Chamber and the corporate treasury community believes that the major rule changes to MMMFs regulations that were implemented in January 2010 were well conceived and strengthened the product to withstand significant market stress. As the SEC considers moving forward with additional regulation, it is incumbent on the Commission to take a balanced and data-driven approach to further strengthen MMMFs while preserving the critical

role they serve for U.S. businesses, state and local governments, non-profit organizations, and for the economy as a whole.

- The SEC's proposed alternative to mandate a floating net asset value (NAV) for institutional prime money market mutual funds would fundamentally alter the product, eliminating the key benefits companies derive from investing in these funds—stability and liquidity. If the floating NAV alternative is implemented, money market mutual funds would no longer remain a viable investment option to many treasurers and financial professionals. Consequently, with fewer investors and less capital to invest, money market mutual funds would no longer remain a significant purchaser of corporate commercial paper. The reduced demand would drive up borrowing costs significantly by forcing companies to fund their day-to-day operations with less efficient and more costly alternatives. It is important to note that the rulemaking in question is discretionary and not mandated by law like the Dodd-Frank Wall Street Reform and Consumer Protection Act, but it will require fundamental changes to existing business operations across the country.

- The Chamber believes the SEC has not substantiated that a floating NAV is the appropriate solution to the problem the Commission is seeking to solve. Even in its proposal, the SEC acknowledges a floating NAV will not necessarily reduce the risk of widespread redemptions during times of market stress. Given the uncertainty as to whether this proposal will protect against a "run" on money funds, we believe it is wholly inappropriate to implement the proposal since it will undermine the value of money market mutual funds while driving up costs drastically, harming corporate growth and job creation.

- The Chamber supports greater transparency with respect to the holdings of MMMFs The daily disclosure of a "shadow NAV" that many mutual fund companies currently report provide investors with the benefits of a floating NAV—real time information regarding the estimated value of fund holdings—without jeopardizing the viability and utility of MMMFs.

**<u>Why Money Market Mutual Funds are Important</u>**

MMMFs play a critical role in the U.S. economy because they work extremely well to serve the investment and short-term funding needs of businesses across America. MMMFs are a critical component of the technologically advanced, real time cash management systems that businesses use to ensure liquidity efficiently and at a

low cost. These efficiencies and savings translate into greater resources for business development and growth.

Corporate treasurers rely on MMMFs to efficiently and affordably manage their company's cash balances, which fluctuate on a daily, weekly, monthly or other periodic basis. Depending on the nature of the business, a company's cash balance can vary significantly—swinging from hundreds of dollars to hundreds of millions of dollars in the red or the black. A corporate treasurer's job is to ensure there is sufficient liquidity to meet working capital needs and money market mutual funds are the most liquid, flexible, affordable, and efficient way to do that both in terms of investing excess cash and obtaining short-term financing.

**Money Market Mutual Funds as an Investment**

As part of treasurers' efforts to ensure adequate working capital for their organizations, they are also typically responsible for directing the investment of their company's cash and pension assets. To do this, treasurers consider all available investment alternatives with the goals to protect principal, ensure liquidity, and prudently maximize returns. These considerations cause treasurers to gravitate toward money market mutual funds because of the stability and liquidity they provide. For companies with cash surpluses, MMMFs offer a stable $1.00 price per share that facilitates efficient accounting of frequent investments and redemptions. The stable net asset value also allows investors to avoid tax implications. Investments in MMMFs can also be made and redeemed on a daily basis without fees or penalties, which promotes the liquidity and efficiency necessary to meet working capital needs.

These funds also offer a diversified and expertly managed short-term investment vehicle that allows companies to invest in one fund while diversifying exposure to a number of underlying short-term investments. Additionally, investment advisors to money market mutual funds perform the credit analysis of the underlying assets so that treasurers and their staffs don't have to spend time and resources analyzing the credit worthiness of multiple individual investments, and can instead just assess the credit quality of the mutual fund itself.

It is important to know that corporate treasurers and financial professionals understand the risk of investing in money market mutual funds. Moreover, we understand that investments in these funds are not guaranteed by the U.S. Government. We are professional stewards of our companies' cash, and we take our responsibilities seriously. MMMFs are attractive to us because they offer a high degree of transparency that enables us to quickly and accurately gauge the degree of risk associated with each fund.

**<u>Money Market Mutual Funds as a Short-Term Financing Source</u>**

MMMFs also represent a major source of funding to the corporate commercial paper market in the U.S. As the SEC notes in its proposal, prime MMMFs held 46.4% of outstanding nonfinancial commercial paper as of December 31, 2013. Without robust MMMFs, demand for commercial paper would drop significantly and the commercial paper market would be substantially less liquid. This source of financing is vital to companies across America as commercial paper is an easy, efficient, and affordable way to quickly obtain short-term financing. Commercial paper programs permit businesses to access the debt markets at the time funds are actually needed and for the specific amount required. The resulting efficiencies have enormous implications for how American businesses operate. U.S. businesses operate with approximately $2 trillion in cash reserves. This represents 14% of the U.S. gross domestic product. By contrast, EU companies carry cash reserves of 21% of EU GDP. If U.S. businesses needed to carry EU-level reserves to ensure access to needed operating funds, they would have to carry an additional $1 trillion in reserves. This is money that would no longer be available for business development, expansion and job creation.

For Great Plains Energy, and other companies in capital intensive businesses, the commercial paper market is a cornerstone to financing the maintenance and expansion necessary to meet the needs of our 830,000 customers. In the last three years, GPE has invested approximately $1.7 billion in infrastructure improvements and new generation facilities. We are anticipating spending another $2 billion in the next three years. In 2010 we completed construction of a new power plant that was the largest single construction project in the State of Missouri during its four-year construction period. That project alone created thousands of jobs for skilled laborers in the Kansas City metropolitan area during difficult economic times. The commercial paper market is an important part of the financing mix for the costs associated with these massive projects.

GPE also uses the commercial paper market to ensure day-to-day liquidity. We operate two commercial paper programs that have a combined available capacity of just over $1 billion. Commercial paper, as a liquidity tool, provides significant cost savings to GPE in the form of lower interest payments on borrowed funds. Currently, GPE offers interest rates to investors on our commercial paper in the current range of 30 to 70 basis points. If instead, we had to use our revolving credit facility with our banks for overnight borrowings, those borrowings would be priced at the Prime Rate plus a spread, which at current rates is at least 3.30% (or 330 basis points), significantly higher than where we can place overnight commercial paper. In

addition, the company would be required to borrow at least $1 million, whereas commercial paper can be sold in increments of $100,000. To request a more comparable, LIBOR-based funding from our bank group would require 3 days prior notice, have a minimum term of 30 days and be for a minimum amount of $5 million and it would still be at a rate about 125 basis points higher than our commercial paper for the same term.

Higher interest rates are not the only costs associated with reliance on revolving credit facilities. Because of the time required to obtain a facility, businesses will need to seek financing in an amount sufficient to cover their greatest possible need for operating cash. As a result, businesses will have to pay for credit facilities that are larger than they will likely need on an ongoing basis. Our banks provide these credit facilities to serve as backup lines for commercial paper issuance. If we need to obtain revolving credit facilities that will be drawn upon in the ordinary course of business, the price of these facilities will likely increase. Most banks prefer not to fund these low-priced credit facilities for investment grade companies. They would rather lend to lower-rated companies that do not have the same access to public markets because they can earn higher returns. This competition for bank lending capacity will only serve to drive up the cost of revolving loan facilities

**2010 Changes to Rule 2a-7**

The Chamber supported changes made just three years ago to money market mutual fund regulation through Rule 2a-7. These changes greatly strengthened these funds. Importantly, they increased the liquidity requirements for money market mutual funds. Funds are now required to meet a daily liquidity requirement such that 10 percent of the total assets can be liquidated into cash in one day and 30 percent within one week. This large liquidity buffer makes it very unlikely a wave of redemption requests—even at the rate seen in the 2008 financial crisis—would force a fund to sell assets at a loss prior to their maturity.

Despite the fact that the 2010 reforms have only recently been implemented, advocates of further regulation have focused much attention on the need to do more. While the Financial Stability Oversight Council and financial regulators have argued for additional regulation, including the implementation of capital requirements to buffer any losses, their approach focuses on mitigating systemic risk without any analysis of the implications of overlaying a bank-like regulatory structure onto the capital markets. Such action works at cross purposes with the mission of the SEC to promote efficient, competitive capital markets and capital formation. Therefore, **it is incumbent upon the SEC to take a data-driven approach to its rulemaking** to

ensure that the rule does not produce more harm to investors, the capital markets and the economy than the benefits it will reap.

While we in concept support further strengthening of money market mutual funds to protect investors, it must be done in a way that preserves the critical roles these funds play in the U.S. economy. As discussed below, we believe that the floating NAV alternative, or any combination that includes a floating NAV, will essentially undermine the ongoing viability of these funds for institutional investors and inflict so much collateral damage on the corporate commercial paper market that it will threaten business expansion and job creation during an already fragile economic recovery period.

**Floating Net Asset Value**

Under the SEC's proposal, prime funds for institutional investors will be required to move to a floating NAV. The use of amortized cost accounting and "penny rounding" would no longer be allowed. Instead of rounding the NAV to the nearest half penny with a $1.00 price per share, the NAV will be calculated using "basis point rounding"—out to four decimal places to $1.0000. As discussed earlier, one of the primary reasons why corporate treasurers and other financial professionals invest in MMMFs is because of the stable $1.00 price per share.

*Loss of Stable Value*

The most important attribute that MMMFs offer to corporate treasurers is stability of principal value. In fact, the Association of Financial Professionals recently released a survey of senior finance and treasury officials at a broad range of companies showing that 68% of respondents indicated that the safety of principal is the most important short-term objective of their organization. Without this stability, many complications and costs arise for U.S. companies.

*Loss of Liquidity*

Almost equally important to corporate treasurers is the ability to have liquid investments. Because of the proposed elimination of amortized cost accounting, it may be much more difficult to redeem MMMF shares and execute intra-day settlements as funds would have to price the underlying portfolio holdings using market based prices constantly throughout the day. If market prices are not readily available, or it is cost prohibitive, funds may not be able to settle with investors until later in the evening or the following day. In essence, liquidity for companies with investments could be impaired.

*Financial Reporting, Tax, and System Issues*

The floating NAV presents another significant concern as gains and losses will arise from the redemption of a floating fund. Although the Internal Revenue Service (IRS) earlier this summer proposed relief from wash sales rules related to a floating NAV, companies must still expend resources to track these gains and losses to ensure that these are *de minimis* (for purposes of the IRS wash sale rule) and for financial reporting purposes. Tracking gains and losses from the redemption of money market mutual funds will require additional manpower and modifications to treasury and accounting systems to build in this capability.

Most treasury workstations used for managing corporate cash do not have accounting systems in place to track NAVs on each transfer into and out of MMMFs. Treasury workstations would need to be upgraded to accommodate these changes, and that investment would significantly lag behind the timing of implementing floating NAVs. As a result, corporate treasurers would likely decide to simply withdraw MMMF investments until the systems issue is resolved, unless adequate transition periods are granted. Some companies will decide to withdraw permanently, rather than incur the expenses and inefficiencies associated with investing in floating NAV funds. At the very least, the systems upgrade costs would force a reallocation of capital expenditure away from more economically productive uses like business expansion and job creation. In a report released by the Chamber earlier this year, Treasury Strategies estimated that the upfront cost to move from a stable to a floating NAV would be between $1.8 and $2 billion with new annual operating costs from $2 to $2.5 billion

Even putting the systems issue aside, many treasurers would refrain from returning to MMMFs to avoid having to record the gains and losses on each investment that would flow through quarterly earnings results. Corporate treasurers diversify fund investments, and as such, are typically in multiple MMMFs at any given time. Tracking the capital gains and losses on each fund where investments and redemptions occur frequently is very complex. Treasurers currently do not have the manpower (or resources) to track this, nor do we have the desire to expend limited resources doing so. We would simply find other, less efficient places for our cash. Taken as a whole, the operational challenges associated with investment in floating NAV funds would outweigh the potential return for many treasurers.

*Issues with Investment Policies and other Covenants and Agreements*

In addition to the operational difficulties a floating NAV would create, the SEC's proposal raises a more fundamental problem arising from the fact that many treasurers are precluded from investing in variable rate instruments. The board of a company has a fiduciary obligation to ensure that the company's available cash is invested in investment vehicles with appropriate liquidity and credit risk. As such, many boards allow investment of cash only in stable value products where there is a low degree of risk of loss as funds intended for liquidity purposes are the lifeblood of any company. If the Commission adopts a floating NAV requirement, many U.S. companies would have to review, assess, and in many cases, revise their companies' investment policies if currently only stable value investments are permitted for cash. The process of rewriting a company's policy is complex because it requires the input of senior executives and ultimately approval by the company's board of directors.

For some companies, rewriting corporate policies in this regard will only be the starting point. Companies may also have debt covenants or other agreements that require cash collateral to be invested in a stable NAV product. Companies would need to spend time and resources to review these agreements, and if found in possible violation, they would then have to renegotiate the contract with the counter party, get them to agree to the change, and then incur legal costs to write and execute a new agreement. Litigation costs could also arise if the parties could not reach a negotiated resolution to the issues associated with the SEC mandating a floating NAV.

*Accounting Classification*

Uncertainty remains about classification of investments in floating NAV funds for financial reporting purposes. In its proposal the Commission simply states that it believes that an investment in floating NAV money market mutual funds would still qualify as a cash equivalent. While the SEC ultimately has accounting standard setting authority and enforcement authority over financial reporting and disclosure violations of publicly traded companies, it would be helpful for the Commission to issue formal guidance on the matter and direct the Financial Accounting Standards Board to conform the Commission's position to existing accounting standards. Without this formality, independent auditors of many companies may be reluctant to take a similar view, and possibly risk placing companies' balance sheets in a weaker cash position.

**Liquidity Fees and Gates**

The second alternative contemplated by the SEC is a mandatory 2% liquidity fee if a fund's weekly liquidity level falls below 15%. Additionally, if this liquidity

threshold is triggered, the fund's board would have the ability to halt redemptions altogether by lowering a "gate." However, it will be left to the discretion of the board to reduce or eliminate the liquidity fee if it deems it to be in the best interest of the shareholders.

The corporate treasurer community has mixed views regarding this proposed alternative. While the liquidity fee and gate is intended to protect investors, its implementation will come with a steep price. If a company's treasurer invests the company's excess cash in a vehicle where a 2% fee on the cash balance is in fact assessed or where the company cannot gain immediate access to its cash because a redemption gate is lowered, it will send a signal to the company's shareholders that the company is negligent in the management of its cash, or in worse case, impact liquidity to the degree of jeopardizing operations. Nevertheless, many corporate treasurers, including myself, do not take issue with this alternative because the risks it presents are realized only when certain liquidity thresholds, which are well below the levels set by the 2010 changes to Rule 2a-7 described above, are crossed and the gate is the only mechanism that will truly stop a run on the fund. Therefore, we view this alternative as placing even greater emphasis on our responsibilities as a steward of our company's cash to assess the risks of investing in a particular MMMF and to monitor on an ongoing basis the mix of investments and liquidity levels in each such fund to ensure prompt access to cash when needed to meet working capital needs.

## Disclosure

The SEC has also proposed additional enhancements of disclosures made to investors regarding the condition and operations of a MMMF. In conjunction with the liquidity fees and gate proposal, the SEC proposes to require funds to disclose daily and weekly liquidity levels. In addition, funds would also have to disclose daily current NAV per share, inflows and outflows, and portfolio holdings. In general, we support additional disclosures that may be helpful for investors to better understand the risks of investing. However, the SEC should be careful not to be so onerous in its disclosure requirements that funds incur significant costs for additional disclosures that will be of little or no use to investors beyond the information that is already available, especially when these investors may ultimately bear the burden of the additional costs associated with new disclosures that may be of little practical value.

## Summary/Conclusion

In summary, corporate treasurers are very concerned about a sizable contraction of the 2a-7 MMMF industry that is likely to result from the changes currently contemplated by the SEC. On the investing side, corporations would be

forced to withdraw from prime money market funds to ensure full access to their money, avoid the recordkeeping and systems modification burden imposed by floating NAVs, and forgo the investment policy changes some of the SEC's proposals will trigger. Companies will instead invest in less flexible bank investment products, other unregulated funds, or individual securities. In so doing, they would lose the efficiency, liquidity, and risk diversification benefit of the 2a-7 structure and increase individual counterparty risk. On the funding side, a decrease in 2a-7 capacity would lead to higher costs and less liquidity for commercial paper issuers and place greater stress on banks to make up the difference with additional lending. There would be greater uncertainty in the daily activities of treasury departments, and that uncertainty would likely lead to more caution in planning capital investments to grow businesses and create jobs.

Rule 2a-7 money market mutual funds are much more than an investment product. Over the last four decades, MMMFs have become a crucial component in a highly integrated system that provides low cost and efficient short-term financing for American businesses. This system has been the gold standard structure around the world for many years. Structural changes, like floating the NAV, will not make MMMFs any less vulnerable to runs, but they will jeopardize the economic viability and utility of MMMFs. Without MMMFs, borrowing costs for many businesses could increase dramatically. American business could be forced to stockpile cash reserves, rather than putting this cash to use innovating, growing, and creating jobs. With the reforms implemented in 2010 to provide greater liquidity, safety, and transparency, these funds have proven to be very stable and attractive investments during a time of great upheaval in global markets related to the European sovereign debt crisis. Altering the structure and nature of money market mutual funds would take away a vital short-term cash management tool for companies throughout the country.

Thank you.

Testimony of Steve McCoy
State Treasurer, Georgia
On Behalf of the
National Association of State Treasurers
before
The House Subcommittee on Capital Markets
and Government Sponsored Enterprises,
Committee on Financial Services
on
"Examining the SEC's Money Market Fund Rule Proposal"

September 18, 2013

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee, thank you for providing the National Association of State Treasurers (NAST) the opportunity to testify on the Securities and Exchange Commission (SEC or Commission) proposal to reform money market funds. I am Steve McCoy, Treasurer for the State of Georgia, and Chair of the Banking and Cash Management Committee of NAST.

NAST is a bipartisan association that is comprised of all state treasurers or state finance officials with comparable responsibilities, from the United States, its commonwealths, territories and the District of Columbia.

State Treasurers, given their important role within the states of ensuring proper cash flow management, have a unique perspective on money market fund regulation.

**Importance of Proposed MMFs Reform to States**

Money market funds (MMFs) are an important investment and cash management tool for many state governments, their political subdivisions and respective instrumentalities. State and local governments rely upon MMFs as short-term investments that provide liquidity, preservation of capital, and diversification of credit risk. Many that use MMFs for short-term investing and cash

management needs have few viable alternatives that have the same or similar features of safety, return, liquidity and diversification of credit risk.

Also, as issuers of municipal debt, states rely on MMFs to buy short-term securities issued by states, local governments and authorities. MMFs are by far the largest purchasers of these short-term bonds, and if reforms limit the attractiveness of MMFs as an investment product, the demand for these bonds will decrease and the financing costs – borne at taxpayer expense – would increase.

Additionally, many states manage Local Government Investment Pools (LGIPs) to provide a safe and efficient investment for state and local government entities. However, changes to the regulation of money market funds, even though they are not registered with the Securities and Exchange Commission, could indirectly impact the operation and viability of LGIPs as a result of the Government Accounting Standards Board (GASB) Statements 31 and 59 requiring externally managed pools to be "2A-7 Like" in order to use amortized cost accounting.

**Alternatives if MMFs are Not Viable Investments for State and Local Governments**

State Treasurers find MMFs an attractive investment when compared to bank deposits or investing directly in commercial paper. Treasurers, as financial stewards of their respective states, have been able to use well-regulated MMFs to improve return. State Treasurers also recognize that MMFs are not guaranteed or backed by the federal government, but MMFs are very transparent and the SEC's 2010 amendments to Rule 2a-7 have made these funds safer and less subject to redemption pressure during periods of stress.

Bank deposits are only insured up to $250,000 and state statutes typically require public fund deposits to be collateralized by marketable securities specified as eligible for pledging. For instance, in the State of Georgia, statutes require most state and local government deposits in banks to be secured by marketable securities valued not less than 110% of the deposits after the deduction of the amount of deposit insurance. The cost associated with collateralizing public bank deposits limits banks from providing competitively priced alternatives.

Investing directly in commercial paper also has transaction costs, custodial fees, less flexibility, and limited liquidity as it does not have an active secondary market. Importantly, another critical

distinction between MMFs and commercial paper is that MMFs allow for greater diversification of credit risks, whereas commercial paper tends to reduce the number of positions an investor has in its portfolio and requires investment staff with credit research training and resources.

**NAST Support for 2010 amendments to Rule 2a-7**

In 2010, the Commission adopted, and NAST fully supported, amendments to Rule 2a-7 that increased the resiliency of money market funds. The changes increased liquidity and credit quality requirements, enhanced disclosures to require reporting of portfolio holdings monthly, shortened portfolio maturities, and permitted a suspension of redemptions if a fund broke the buck or is at imminent risk of breaking the buck. NAST believes these reforms have made money market funds more transparent, less subject to interest rate risk, and less susceptible to redemption demand pressure during periods of stress in the financial markets.

**SEC's MMF proposal**

The Commission's proposed money market fund reforms include one or a combination of the following two alternatives: (1) require a floating Net Asset Value ("FNAV") for prime institutional money market funds, with exemptions for government MMFs (those that are invest at least 80% of their assets in federal government securities) and those considered "retail" MMFs (those that limit each shareholder's redemptions to $1 million per day); and/or (2) require the imposition of liquidity fees if a fund's weekly liquid assets fall below a certain threshold (unless the fund's board determines such fee is not in the best interest of the fund), in conjunction with permitting redemption suspensions during times of market stress ("Fees and Gates"). The proposal also includes disclosure reforms, additional diversification requirements, and stress testing reforms.

NAST has worked with many state and local groups that are similarly concerned about implementation of the SEC proposal. Please find attached four letters co-signed by NAST and a broader coalition of concerned state and local groups. NAST hopes to work with the SEC and the Government Accounting Standards Board (GASB) to address the concerns described this testimony and in the NAST comment letter, which I have attached to this testimony.

**Impacts on States as Investors of MMFs**

As explained above, states invest in MMFs as an efficient tool for managing large volumes of short-term liquid assets. MMFs that seek to maintain a stable net asset value per share are permitted investments for many states and local governments; however, variable or floating NAV MMFs generally are not permitted investments. Few other investment options permitted of states provide the same features MMFs offer: safety; return; liquidity; and stable NAV. NAST is concerned that significant changes to the regulation and structure of MMFs could make them less useful or suitable as cash management tools, thereby forcing states to turn to less liquid and perhaps lower yielding alternatives.

**Impact on States as Short-term Issuers of Municipal Securities**

As issuers of short-term debt, states benefit from municipal MMFs that purchase such short-term securities. Although bank loans and purchases of notes by banks and other institutional investors are at times an option, municipal MMFs offer a reliable low-cost option for municipal borrowers.

If a floating NAV is applied to municipal MMFs it could lead to less investor demand in these funds, ultimately resulting in higher funding costs to issuers of short-term issuers of municipal securities. While the Commission suggests in its release that most investors in municipal MMFs are retail investors and could therefore avail themselves of the retail exemption from the floating NAV requirement, we understand that a significant portion of municipal MMFs balances is made up of institutional investors. Since municipal MMFs have been very stable through many market cycles and did not experience large redemptions in the 2008 financial crisis, imposing a floating NAV on such funds seems entirely unnecessary.

**Indirect Impact on Local Government Investment Pools (LGIPs)**

The SEC's two proposed alternatives, FNAV and/or Fees and Gates, could pose significant risks to LGIP participants. First, allow me to provide background on LGIPs and their operation.

LGIPs have been created by several states and operated by State Treasurers or authorized governing boards for the exclusive benefit of governmental entities within each state. Unlike money market funds, LGIPs are not open for investment to the public. Instead, LGIPs exist to provide a

service to state and local government entities that otherwise would have difficulty investing public funds safely and efficiently. While each state's statutes governing LGIPs may be different, LGIPs generally accept deposits from cities, counties, colleges, school districts, and other state and local government entities. In some cases, the states that sponsor LGIPs commingle their own assets with those of the other LGIP participants to achieve economies of scale.

LGIPs are often used by participants as short-term investments for funds that may be needed on a day-to-day or near-term basis. Therefore, most participants use LGIPs for principal preservation and as an efficient cash management tool, including using LGIPs for operating liquidity or for investing proceeds used for debt repayment. State and local government entities are understandably loss averse because of the importance of protecting taxpayer money, but such entities may also have legal restrictions, budgetary constraints, investment limitations or liquidity requirements as reasons for their low risk tolerance.

LGIPs are exempt from SEC regulation under section 2(b) of the Investment Company Act because of their sovereign ownership. However, depending on future actions of the Governmental Accounting Standards Board (GASB), the Commission's proposed changes to money market fund regulation could have the unintended consequence of indirectly impacting the ability of some states to service LGIPs for their state and local government entities. The reason for this is that GASB reporting statements 31 and 59 reference the SEC's Rule 2a-7 governing money market funds. Therefore, while an LGIP is not registered with the SEC as an investment company, an LGIP that operates as a "2a-7 like" pool consistent with GASB rules must operate in a manner consistent with the SEC's Rule 2a-7, unless the GASB changes the reporting statements to recognize the unique characteristics of LGIP participants (state and local government entities), sponsors (states) and their statutory requirements.

Converting an LGIP to a floating NAV pool or imposing liquidity fees as a charge against participants' account balances would be in violation of some states' statutes and prudent investment policies. Governmental entities cannot tolerate loss of principal on operating funds, trust funds, or bond proceeds because they have no method of replenishing such losses.

Furthermore, LGIPs would be unable to avail themselves of the proposed retail or government fund exemptions.

A very large number of LGIP participants have minimal activity in their accounts (less than $1 million daily). However, other participants have sizable accounts and routinely withdraw more than $1 million per day for operating expenses or to make bond payments, making LGIPs unable to operate as "retail" and exempt from the FNAV proposal.

Most LGIPs would not fit in the government fund exemption. An election by a "2a-7 like" LGIP to use the government fund exemption would be problematic as it would lower yields and likely result in fewer participants and fund balances. In addition, such an LGIP could experience problems in an extremely low or negative interest rate environment, which would force LGIPs to purchase short-term government securities at negative yields. Even at zero or slightly positive rates, the overall yield on a government only pool would likely be too low for an LGIP sponsor to cover operating expenses and result in a loss of principal if the sponsor could not subsidize its operating costs.

**Conclusions**

NAST believes the Commission's 2010 MMF reforms have made MMFS more transparent, less subject to interest rate risk, more creditworthy and less susceptible to redemption demand pressure during periods of stress in financial markets. While NAST appreciates the Commission's efforts in the regulation of money market funds, NAST remains concerned that some of the proposed changes will have unintended consequences for states, cities, counties and other municipal entities. If the Commission moves forward with additional changes to Rule 2a-7, we urge the Commission to: (a) understand not only the direct impact the rule would have on MMF investors and on short-term issuers of municipal securities, but also the indirect impact on LGIPs and the municipalities that invest in LGIPs; and (b) exempt municipal MMFs from the rule, just as federal government MMFs are exempted. In addition, if the Commission significantly modifies Rule 2a-7, we urge the GASB to consider the unique characteristics of state and local government entities, including their redemption histories, investment policies, and statutory requirements.

NAST stands ready to work with the Commission, GASB, and Subcommittee on these important issues.

NATIONAL ASSOCIATION OF STATE TREASURERS



September 16, 2013

Ms. Elizabeth M. Murphy, Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Comment on the Proposed Rulemaking on Money Market Fund Reform
File No. S7-03-13

Dear Ms. Murphy:

The National Association of State Treasurers ("NAST") appreciates the opportunity to provide comments on the proposed rulemaking of the U.S. Securities and Exchange Commission (the "SEC") on money market funds ("MMFs").[1] NAST is a non-partisan membership organization composed of all state treasurers, or state finance officers with comparable responsibilities, from the United States, its commonwealths, territories and the District of Columbia. As the chief investment officers of the states, state treasurers directly manage billions of dollars in state and local government funds. They have a direct stake in their respective states' financial well-being as well as in the health of the nation's economy. Treasurers diligently share their expertise in fiscal and investment matters with other government officials and with the general public. NAST seeks to provide educational conferences and webinars, publications, working groups, policy advocacy and support that enable states to pursue and administer sound financial policies and practices of benefit to the citizens of the nation.

We have divided our response into the following sections to address three distinct concerns State Treasurers have in regards to the SEC's proposed rule changes. These three concerns are:

**I.** Impact on Local Government Investment Pools ("LGIPs")
**II.** Burden on States as Purchasers of Money Market Funds ("MMFs")
**III.** Higher Funding Costs to Issuers of Short-term Municipal Securities

**I.** Impact on Local Government Investment Pools ("LGIPs")

Because of their sovereign ownership, LGIPs are exempt from SEC regulation under section 2(b) of the Investment Company Act. However, the proposed changes to Rule 2a-7, if adopted, could significantly harm the financial condition of state and local governments. Therefore, we believe it is important to provide comments to the SEC in connection with its proposed changes to Rule 2a-7.

In Section III(A)(6)(C) of the rulemaking release, the SEC requests comment as to the potential impact of the proposed rulemaking on LGIPs that operate as cash investment vehicles used exclusively for the investment of public funds.

LGIPs have been created by several states and operated by State Treasurers or authorized governing boards for the exclusive benefit of governmental entities within each state. LGIPs are created to provide a service to state and local government entities that otherwise would have difficulty investing public funds safely and efficiently. Although enabling legislation of each state's LGIP is unique, they all share common objectives – to provide safety of capital and liquidity while optimizing interest for participating state and local entities. In most cases, they are designed to serve as short-term investments for funds that may be needed by participants on a day-to-day or near term basis. Most participants use LGIPs for both principal preservation and as a cash management tool. Consequently, LGIPs attract public fund investors who are unable or unwilling to tolerate even small losses. Such entities can be loss averse for a variety of reasons, including general risk tolerance, legal restrictions, budget constraints, investment limitations, or liquidity requirements.

Unlike MMFs, LGIPs are not open for investment to the public. Eligibility to invest in LGIPs is determined by state statutes, and accountholders must be approved prior to investing. LGIPs are not designed to compete with the private sector for investment dollars. LGIPs accept deposits from cities, counties, colleges, school districts, authorities and other government entities that need to safeguard operating funds, trust funds, bond proceeds, fiduciary funds, reserve funds and other funds that must remain liquid. Additionally, some states that sponsor LGIPs commingle their own assets with those of LGIP participants to benefit from economies of scale. In such cases, the State that administers the LGIP is often the largest accountholder.

Many, but not all LGIPs are indirectly impacted by the SEC as a result of references to Rule 2a-7 in Governmental Accounting Standards Board (GASB) reporting statements 31 and 59. Rule 2a-7 allows MMFs to use amortized cost to report net assets. A "2a-7 like" pool is not registered with the SEC as an investment company, but nevertheless has a policy that it will, and does, operate in a manner consistent with Rule 2a-7. Also as GASB 31 explains, governmental external investment pools that are "2a-7 like" pools are permitted to report their investments at amortized cost. GASB 59 (issued June 2010) clarified GASB 31 to indicate that a "2a-7 like" pool, as described in GASB 31, is an external investment pool that operates in conformity with SEC Rule 2a-7 as promulgated under the Investment Company Act of 1940, as amended. According to GASB 59, to qualify as a "2a-7 like" pool, the pool should satisfy all SEC

requirements of Rule 2a-7, including that a group of individuals fulfills the functions of a board of directors.

State and local governments are permitted to use amortized cost accounting to value short-term debt instruments with a remaining maturity of up to one year that are held directly or through a single-government pool ("internal pools"). Under current GASB and many states' accounting guidance, LGIPs that accept investors from more than one governmental entity ("external pools") are also permitted to use amortized cost to value portfolio assets under any of several different sets of conditions. GASB Statements 31 and 59 prescribe use of amortized cost by external pools to conform to most Rule 2a-7 requirements. This method is available to those LGIPs that voluntarily comply with Rule 2a-7 and operate as "2a-7 like" external pools. The specific conditions of Rule 2a-7 referenced in the guidance supportive of this accounting treatment include asset quality, portfolio maturity, liquidity, and diversification requirements. These conditions in the current Rule 2a-7 help assure the stable asset value of LGIP portfolios.

LGIP participants have limited investment alternatives that vary from state to state. Individual state statutes specify eligible investments, which typically include, but are not limited to, collateralized bank deposits, U.S. treasuries and agencies, and in some states, MMFs. Should some LGIPs that operate as "2a-7 like" pools find themselves unable to adjust to the proposed Rule 2a-7 changes, they may have to scale back or cease operations. This would cause participants to seek other legally eligible investment alternatives for potentially billions of dollars. Numerous governmental entities, many with little or no investment experience would face losing the most reliable and cost-effective investment vehicle they have depended on, some for nearly forty years, without a problem. Should such disruption occur, most local government participants would likely look to their local banks for investing the cash. However, acceptance of governmental deposits is costly and burdensome to banks due to the high cost of collateralizing public bank deposits, a common requirement among most states to safeguard public funds. Banks without an existing relationship with a local government may not have an appetite for additional deposits nor offer an attractive interest rate.

As stated above, public fund bank deposits are typically required by state statutes to be collateralized by marketable securities specified as eligible for pledging. For instance, in the State of Georgia, statutes require most state and local government deposits in banks to be secured by marketable securities valued not less than 110% of the deposits after the deduction of the amount of deposit insurance. If participants in Georgia's $9.3 billion LGIP were to seek local banks to accept their current LGIP deposits, banks could only accept those funds if they pledged over $10 billion in eligible securities as collateral. Many local governments do not have the expertise or analytical tools to assess and monitor the financial strength of counterparties or determine the value and liquidity of pledged securities.

Also, local governments may not realize that some bank products carry unacceptable liquidity constraints imposed per the "Reserve Requirements of Depository Institutions (Regulation D)" which could prohibit government entities from having immediate access to their funds. Unlike private participants, governmental entities typically do not have the capability or

authorization to borrow funds to cover temporary shortfalls and therefore liquidity is paramount to their investment needs. As stated above, any liquidity constraints imposed by banks could result in payment defaults by municipalities.

Any disruption of LGIPs would force participants into direct investments that may not be suitable for their risk tolerance and would reduce their portfolios' diversification compared to investing in an LGIP. By pooling funds, participating governments benefit from economies of scale, full-time portfolio management, diversification and liquidity. LGIPs have investment staff, systems to evaluate securities, custodians for safekeeping assets, and the means to sustain these systems and services. Most LGIPs allow for daily or next day liquidity for participants. Also, LGIPs are typically low cost providers for budget-strapped governments. For instance, the costs to States to administer LGIPs is typically well below the management fees charged by most MMFs.

For the most part, LGIPs are typically buy and hold portfolios. Therefore, many securities that fall in the 2a-7 space are not actively traded. A lack of active trading means there is no true market value at the end of each day for these securities.

"Mark-to-Market" is a misnomer in the context of both LGIPs and MMFs. To calculate the daily or "shadow" NAV of a money market fund, most pricing services use a matrix to determine the value of these securities. Current market prices on a small subset of money market instruments that trade are extrapolated by the model to estimate the current value of most LGIP assets based on similarities and differences in maturity, credit risk and other historical pricing relationships. A set of amortized cost-like assumptions is factored into the model to extrapolate among the values of instruments that have different maturity dates. Model pricing is not a true market price, is not more accurate in establishing market values, and it is not devoid of amortized cost-like assumptions. The difference between this "mark-to-model" pricing of a portfolio and amortized cost pricing of the same portfolio is very small, and is not material in the context of the value of the shares, particularly where rounded to the nearest cent. It is noted in the SEC proposal "that the vast majority of money market fund portfolio securities are not valued based on market prices obtained through secondary market trading because the secondary markets for most portfolio securities such as commercial paper, repos, and certificates of deposit are not actively traded."[1] Thus the calculated NAV would prove to be a very costly and inaccurate assessment of the value of an LGIP. State LGIPs cannot afford such changes and the assessments would not benefit our participants. LGIP participants would be subjected to confusion, high costs, operational inefficiencies and heightened risk of errors.

Other LGIPs that are not "2a-7 like" pools are permitted to use amortized cost to value short-term money market portfolio assets (i.e. those assets with 90 or fewer remaining days to maturity) as well as certain longer-term "non-participating" money market instruments (i.e. non-marketable debt instruments that do not take market changes into account in redemption features). Changes to Rule 2a-7 will not change this. Moreover, as the SEC notes, amortized cost

[1] 78 FR 36837 (June 19, 2013).

is not required to maintain a stable net asset value of $1/share for an LGIP when prices are rounded to the nearest penny per share. GASB guidance does not require an LGIP to be a "2a-7 like" pool in order to round shares to the nearest penny or to attempt to maintain a price of $1 per share. However, use of amortized cost to value portfolio assets is far more efficient than using "mark-to-model" pricing and is shown to be as reliable. A movement away from amortized cost accounting by LGIPs, to the extent indirectly triggered by changes to Rule 2a-7, would impose administrative and staffing burdens, significant expenses, slow settlement times, and increases in settlement risks for LGIPs. Particularly given the low interest rate environment, LGIPs would be unable to obtain funding from pool earnings to cover such expenses and the possibility of obtaining state appropriations in most cases is unlikely given tight state budgets and timing for consideration of budget matters. States may also face statutory prohibitions to assessing charges against existing participants for modifications that will affect future participants only, a group not necessarily composed of the same entities especially if a number of current participants leave the pool if the proposed changes were implemented.

It remains to be seen whether amendments to Rule 2a-7, prohibiting the use of amortized cost to value assets with remaining maturity of more than 60 days, as well as effectively banning penny rounding, would be applied to a "2a-7 like" LGIP. This could be interpreted as a condition for an LGIP using amortized cost to value portfolio assets of up to a year in remaining maturity and rounding shares to the nearest cent. Requiring "2a-7 like" LGIPs to use an accounting method other than amortized cost for assets with a remaining term over 60 days and not seek to maintain a stable NAV, as conditions to using amortized cost or penny rounding, would appear to be logically inconsistent. Therefore, such conditions would not seem to be elements of Rule 2a-7 that "2a-7 like" LGIPs would be required to follow.

The SEC's two proposed alternatives, floating NAV and/or liquidity fees or gating, for amending rules that govern MMFs could pose significant risks to participants in LGIPs to the detriment of the financial condition of those municipal entities. As stated in the SEC's current money market fund reform proposal, "We understand that investors use money market funds for cash management, and that lack of access to their money market fund investment for a long period of time can impose substantial costs and hardships."[2] If an LGIP were to be gated, participants would have to wait for their money scheduled to be withdrawn to meet payroll, vendor payments and debt repayments. We acknowledge that over a 40-year period there have been a few LGIPS, two that we are aware of, that utilized gating in a crisis while the sponsor assessed its options. However, this is not a viable strategy that LGIPs should adopt as a means of operation. The problem with liquidity fees and gating alternatives for LGIPs would be that many participants could not afford to lose their liquidity or accept loss of principal. Public fund investments in LGIPs are typically earmarked for operational liquidity. Most LGIP participants do not have liquidity lines or other authorized methods to borrow funds should their operating funds become unavailable due to an LGIP being gated.

[2] 78 FR 36888 (June 19, 2013).

With some LGIPs dating back to the 1970s, modifications to their structure would be highly problematic, expensive, time consuming and uncertain in terms of accomplishing well-intentioned, but unnecessary, modifications. Each state's enabling legislation differs, but many, if not most, require the state as its' sponsor to invest with the first priority being safety of participants' capital. Managing LGIPs to maintain a stable net asset value clearly satisfies that criterion, but converting to a floating NAV or imposing liquidity fees as a charge against participants' account balances would be in violation of some states' statutes and prudent investment policies. Governmental entities cannot tolerate a loss of principal on operating funds, trust funds, or bond proceeds because they have no method of replenishing such losses. State Treasurers and legislators would be hard pressed to approve legislation that would potentially harm their own local governments and state entities with deposits in their LGIPs.

Enabling legislation for numerous state and local entities allows such governmental bodies to invest in their respective state LGIP due to it maintaining a stable net asset value that protects principal and allows participants to withdraw funds as needed. Thousands of municipal bond indentures permit proceeds to be invested in the respective state LGIPs for the same reasons. In the proposal, the SEC notes that "Our floating NAV proposal, if adopted, may have implications for LGIPs. In order to continue to manage LGIPs, state statutes and policies may need to be amended to permit the operation of investment pools that adhere to rule 2a-7 as we propose to amend it. Because we are unable to predict how various state legislatures and other market participants will react . . . we do not have the information necessary to provide a reasonable estimate of the impact on LGIPs or the potential effects on efficiency, competition, and capital formation. We note, however, that it is possible that states could amend their statutes or policies to permit the operation of LGIPs that comply with rule 2a-7 as we propose to amend it." Although the SEC may be correct in stating that such statute and policy changes might be possible, in many states such actions would be impractical. It would not be feasible for some states to embark upon a course that would require legislative and even bondholder approvals in order to modify LGIPs to comply with MMF regulatory changes which, if adopted, could actually increase risk for LGIP participants and bondholders. To amend a state's investment statutes is time-consuming and uncertain, especially if the objective is to restructure LGIPs that have been proven safe and effective. Most state legislatures meet for a few months annually, but some state legislatures meet bi-annually. Even more problematic is the burden such changes would impose on municipal bond issuers with trust indentures that authorize investments in LGIPs in order to protect principal and provide ready access to funds.

The proposed SEC rule changes classify MMFs as either retail or institutional and provide an exemption for retail funds. Unlike private MMFs, LGIPs are not classified as either retail or institutional funds since eligible participants are defined by enabling legislation and range in size of account balances and transactions as well as financial sophistication. LGIPs are established and designed to serve a variety of unique investors – state and local entities of a wide range of sizes and needs – that often have no other permitted investment options that meet their investment needs. Most LGIPs experience cyclical asset flows based on tax payments and receipts, bond proceeds, and salary and benefit payments, to name a few. State Treasurers, as sponsors of LGIPs, must assure participants that portfolios are managed so that sufficient monies

are available to fund participants' withdrawal needs and their principal has not diminished. A very large number of LGIP participants carry small balances (less than $1 million) and have minimal activity in their accounts. However, LGIPs also serve state and local governments that have sizeable accounts. Often participants use the LGIPs as a source of operating liquidity (some as an alternative to a bank DDA account) or for investing proceeds used for debt repayment. Some LGIP participants routinely withdraw more than $1 million per day for operating expenses or to make bond payments. For many LGIPs, a small number of shareholders make up a substantial percentage of the fund and thus have withdrawals that are in excess of $1 million. For example, in the State of Georgia, the Department of Revenue has partnered with the Office of the State Treasurer to set up LGIP accounts for those municipalities choosing to have their sales tax collections electronically transferred from the Department of Revenue to the LGIP. For the large metro counties in Georgia, these monthly deposits are over $10 million per month. Eventually these funds are used for operating purposes and the draws for these large metro counties are well in excess of $1 million per day. These counties are legally entitled to withdraw their sales tax collections as needed without charge or delay.

Although most LGIP participants do not meet the definition of a retail type shareholder based on the size of their withdrawals, their withdrawal history reveals that their behavior more closely models a retail type investor than an institutional type investor. As noted on page 73 of the SEC proposal, "Institutional shareholders tend to respond more quickly than retail shareholders to potential market stresses because generally they have greater capital at risk and may be better informed about the fund through sophisticated tools to monitor and analyze the portfolio holdings of the funds in which they invest."[3] However, LGIP participants, like retail investors, tend to be more patient. An appropriate assessment of the participants who typically use LGIPs was given by Kathryn L. Hewitt of the Government Finance Officers Association, as cited in footnote 72 of the proposal: "Most of us don't have the time, the energy, or the resources at our fingertips to analyze the credit quality of every security ourselves. So we're in essence, by going into a pooled fund, hiring that expertise for us…it gives us diversification, it gives us immediate cash management needs where we can move money into and out of it, and it satisfies much of our operating cash investment opportunities." The profile of many LGIP participants more closely models the mindset of retail investors in MMFs, meaning that LGIPs do not typically experience heavy redemptions based on participants' fear of credit issues, illiquid securities, or safer opportunities outside the LGIP. Furthermore, the stability of LGIPs is evidenced by their not being viewed as systemically important and therefore were not offered the same government guarantee as were MMFs in September 2008.

Likewise, most LGIPs do not and cannot fit in the "government only" category. An LGIP that traditionally has provided competitive rates to participants would risk tempting participants to withdraw funds looking for higher yielding, riskier options if the LGIP moved to convert to government only MMF in order to continue to use amortized cost. Both the lower yields and reduced deposits would produce financial hardships on LGIP sponsors who already operate at very slim margins. However, an election by a "2a-7 like" LGIP to use the government only

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[3] 78 FR 36856 (June 19, 2013).

exemption in the proposed rule changes would be problematic for another reason. Although government only MMFs seek to preserve principal and maintain liquidity, an LGIP designed to be a "2a-7 like" government only fund could experience problems in extremely low or negative interest rate environments. Government only funds are required to keep 30% weekly liquidity and may be forced to accept negative interest rates that would in effect erode principal. Purchasing securities carrying a negative yield, as short term U.S. Treasuries did on September 28, 2012, would violate state statutes and investment policies that treasurers first consider the probable safety of capital when buying any security. As stated above, most LGIPs must invest funds considering first the probable safety of capital and then the probable income to be derived. In a negative interest rate environment, particularly triggered by a flight to quality into securities backed by the full faith and credit of the U.S. government, LGIPs attempting to operate as 'government only' type pools would have no alternative but to purchase overnight repos backed by U.S. governments or short term U.S. Treasuries at negative yields. Even at zero or slightly positive rates, the overall yield on a government only pool would likely be too low to cover operating expenses and result in a loss of principal if the sponsor could not subsidize operations. Clearly, LGIPs seeking to protect accountholders by maintaining a stable NAV in times of market stress should not be constrained by rules requiring it to either violate investment statutes and policies designed to preserve principal or lose its ability to use the amortized cost method for valuing the pool.

GASB Statements 31 and 59 do not contemplate Rule 2a-7 providing options for sponsors to select from depending on the make-up of their participants, size of participants' withdrawals, history of withdrawals during times of financial stress or other factors. We hope GASB would provide clarification as to how external pools can continue utilizing amortized cost if Rule 2a-7 no longer prescribes a viable methodology for operating a stable net asset value pool which, as emphasized, is the primary objective of most LGIPs.

NAST agrees with the SEC's statements that changes to Rule 2a-7 do not directly or immediately apply to LGIPs. However, the SEC's proposals could affect LGIPs indirectly, depending on future actions of GASB and on individual states in establishing the operating and accounting standards for LGIPs. Changes to Rule 2a-7, whether moving to a floating NAV, which prohibits the of use of amortized cost accounting in valuing portfolio assets, or imposing gating and liquidity fees, would require considerable time and expense for state and local governments. This would depend on the terms of each LGIP's requirements and whether sponsors opt to mirror the changes implemented by an amended Rule 2a-7. The process for each LGIP's sponsor to analyze the need and suitability of possible statutory or policy changes and, if necessary, drafting, lobbying, adopting, disclosing and implementing those changes, would burden government sponsors with significant costs in an environment without any revenue sources of funding such changes. There is also a great deal of uncertainty that such changes would be approved by the respective governmental bodies.

To the extent that LGIPs were indirectly forced into a floating NAV, or required to abandon use of amortized cost accounting, the usefulness of LGIPs to numerous state and local government entities would be greatly diminished. This would result in disruption as public sector

Ms. Elizabeth M. Murphy
September 16, 2013
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investors sought to redirect investments with few viable alternatives, especially for small to mid-size entities with limited bank or other counterparty willingness to accept collateralized interest-bearing deposits. State and local governments would face complex decisions in determining viable options for investing funds that have, historically, been deposited into stable value LGIPs. Legality, affordability, and suitability among other factors would substantially limit investment options for public sector investors.

Should the SEC adopt its proposed changes to Rule 2a-7 with an effective two-year phase-in period for MMFs, LGIPs would be at a distinct disadvantage that may prohibit continuation of any LGIP opting to be "2a-7 like". Since GASB regulations do not consider multiple options and exemptions for LGIPs to choose among in order to continue using amortized cost accounting, any consideration by GASB to amend its Statements 31 and 59 would take time to consider, possibly as long as two years. State treasurers could not even consider policy or statutory changes until GASB determined whether to amend its current regulations. In addition, state legislatures require significant time to research, debate, and promulgate legislative changes. Bond issuers also would require much time to explore whether indentures could be changed to protect bondholders if the prescribed investment in LGIPs would no longer be stable NAV. Alarmingly, LGIPs would have to continue to operate under great uncertainty while private MMFs adjust to new rule changes. This inequity would be extremely detrimental to LGIPs, sponsoring states, and all participants.

It is also disconcerting that, at a time that the SEC has proposed to put restrictions on MMFs to eliminate their using amortized cost accounting, federal banking agencies recently amended rules governing the accounting treatment of bank short-term investment funds ("STIFs"), which are a form of pooled investments used by bank trust departments as a MMF alternative to invest cash balances of state and local governments, trust accounts and pension plans.[4] The bank STIF rules were amended to include several aspects of SEC MMF rules, but continue to allow the use of amortized cost accounting to value portfolio assets, penny rounding to establish unit prices, and allow STIFs to seek to maintain a stable NAV of $1/unit. As with Bank STIFs, there appears to be no overriding accounting, policy or legal reason to apply all aspects of the SEC's MMF rules to the accounting treatment of LGIPs.

**II.** Burden on States as Purchasers of Money Market Funds

In addition to providing a response from NAST that addresses concerns associated with the effect on LGIPs, we believe it is useful to include insight and other valuable comments regarding states that invest in MMFs.

Many NAST members use MMFs extensively. As investors, states use MMFs as an efficient tool for managing large volumes of short-term liquid assets. MMFs that seek to maintain a stable value per share are permitted investments for many of our members, which rely on these funds to obtain ready liquidity, preservation of capital, and to provide diversification.

[4] 12 C.F.R. 9.18(b) (4) (iii); 77 Fed. Reg. 61237 (Oct. 9, 2012).

Variable NAV MMFs generally are not permitted investments for our members for cash positions. Few other permitted investment options provide the same features of safety, return, liquidity, and stable market history as MMFs that seek to maintain a stable NAV.

NAST is concerned that major changes to the regulation and structure of MMFs could make them less useful or otherwise unsuitable to our members as a cash management tool.

**III.** Higher Funding Costs to Issuers of Short-term Municipal Securities

In addition to providing a response from NAST that addresses concerns associated with the effect on LGIPs, as well as comments pertaining to states that invest in MMFs, we believe it is useful to include additional insight regarding states as issuers of short-term municipal securities purchased by MMFs.

As borrowers, states benefit from MMFs, particularly municipal funds, as purchasers of short-term debt issues.

Although bank loans and purchases of notes by banks and other institutional investors are usually an option, MMFs offer a reliable low-cost option for municipal borrowers. As a result, changes to MMF structure and regulation could impose significant costs and burdens on state and local governments and indirectly on our citizens.

NAST is also concerned that a floating NAV, if applied to municipal MMFs, could lead to an exodus of investors from those funds. This would reduce the availability of short-term municipal financing and drive up the cost of financing short-term borrowing needs. Access to short-term financing allows some state and local governments to bridge the timing gaps between tax revenues and budgeted expenditures. The SEC implies in its release that all investors in municipal MMFs are retail investors, and thus these funds could readily avail themselves of the "retail" exemption from the floating NAV requirement. We understand, however, that a significant portion of the balances in municipal MMFs is made up of institutional investors. Moreover, the "look through" provision in alternative one, which would look to the ultimate beneficial owners of omnibus accounts to set the daily $1 million redemption limit for a retail fund, appears to have many operational and legal complexities that may make it far less suitable than the SEC suggests. These two factors could result in many investors leaving municipal MMFs and other MMFs not qualifying for the "retail" exemption from the variable NAV requirement contained in alternative one. Either outcome would lead to a decline in MMF assets, to the significant detriment to our members and their citizens. Given that municipal MMFs have been very stable through many market cycles and did not experience large redemptions during the 2008 financial crisis, imposing a floating NAV upon them as a means to address investor "runs" seems entirely unnecessary. Accordingly, NAST believes strongly that municipal MMFs should be similarly exempted from the Floating NAV and the Fees/Gates alternatives as is proposed for Government MMFs.

NAST is also concerned about the potential adverse impact upon our members' access to

financing from MMFs that could result from the SEC's proposal to eliminate the "25% basket" that currently permits MMFs to exceed the 10% limit on securities subject to guarantees and demand features from a single provider. Over the past two decades there has been a substantial reduction in the number of banks and insurance companies that provide credit support to municipal obligations. Due to the limited number of credit support providers for municipal obligations, the SEC's proposed change may have a particularly adverse impact upon state and local government access to financing from MMFs. Given the small number of credit support providers, the SEC's proposed change could effectively cap the aggregate amount of municipal debt that can be held by any single MMF regardless of the underlying credit of the issuers.

NAST is concerned that major changes to the regulation and structure of MMFs could cause a significant shrinkage of the MMF market thereby reducing their funding as a source of short-term financing for municipal entities.

**CONCLUSION**

In conclusion, as evidenced in our comments above, NAST is concerned that the SEC would act to the detriment of state and local governments if it adopts either of the two proposed alternatives to Rule 2a-7 or a combination of the two. The most harm would be to the states that operate or otherwise have authorized LGIPs. Also, as investors, the value we derive from investing in MMFs with stable NAVs would reduce our efficiency and increase our costs. Third, MMF purchasers of our short-term debt would be unfairly treated in comparison with MMFs purchasing U.S. government obligations and their reduced appetite for municipal debt would drive up our cost of capital. As stated by the Investment Company Institute (ICI), "The SEC proposal favors financing the federal government over the funding needs of state and local governments. It is important to the taxpayer that all governmental financing achieve the lowest cost."[5]

NAST does not believe that further changes to the regulation of MMFs are needed. The SEC's 2010 amendments to Rule 2a-7 have worked as designed to significantly enhance MMF liquidity, credit quality, risk management, and transparency. Paul Schott Stevens, President and CEO of ICI, emphasizes "As members of the commission themselves noted, those 2012 proposals were drafted without a proper economic study on the impact of the 2010 reforms".[6] We do not believe additional changes are appropriate given the high costs for MMF sponsors to implement and administer especially since there is no evidence that the proposed changes would enhance the stability of MMFs or reduce systemic risks in the economy.

Furthermore, given that many state LGIPs operate as "2a-7 like" funds, the excessive costs and burdens to implement and maintain the proposed changes and modifications to proven cash management vehicles for municipal governments would put many LGIPs at risk of

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[5] ICI (8/27/13).*The Public Investor's Viewpoint [PowerPoint Slides].Retrieved From: Money Market Fund Regulation Webinar*

[6] Paul Schott Stevens, *"Top of the Ninth? The State of Play for Money Market Funds, June 19, 2013,* http://www.ici.org/pressroom/speeches/13_pss_crane_symposium.*(accessed 8/27/2013).*

participant withdrawals or ceasing operation due to insufficient funding especially in this low rate environment. It should be made clear by the SEC that any changes to reform MMFs are not intended to affect LGIPs. NAST believes the SEC should not implement any rule change that might be interpreted as attempting to coerce LGIPs to choose between compliance with Rule 2a-7 or prudently protecting their participants' capital and liquidity. Should Rule 2a-7 changes trigger unintended problems for state and local governments, the governments most strapped for funds and those in communities least served by large financial institutions will experience the greatest financial harm. The financial impact on state and local governments could well harm economic growth, market efficiency, jobs creation, competition, and credit worthiness of municipal governments across the U.S.

In summary, the SEC's proposed rule changes would be detrimental to competition, efficiency, and capital formation for our members as well as cities, counties, and other municipal entities. We do not believe additional changes to money fund regulation are needed at this time. If further changes are adopted, however, we urge the Commission to (a) include a comment that it is not the SEC's intent to promulgate changes to LGIPs, and (b) create an exemption for municipal money funds equivalent to that established for U.S. Government MMFs under the proposal. As State Treasurers concerned about the financial strength and integrity of states and all governmental units within our states, we appreciate this opportunity to offer our views on this matter.

Thank you for your consideration.

Sincerely,

Manju Ganeriwala

Manju S. Ganeriwala
President, National Association of State Treasurers
State Treasurer, Commonwealth of Virginia

Government Finance Officers Association
International City/County Management Association
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Treasurers
National League of Cities
National Association of Counties
U.S. Conference of Mayors
American Public Power Association
Council of Infrastructure Financing Authorities

August 19, 2013

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chair White,

The undersigned organizations listed above represent state and local governments and public infrastructure development agencies that rely on money market mutual funds ("MMMFs") to meet their investment and short-term financing needs. Our organizations have long supported efforts to strengthen MMMFs while ensuring the preservation of this vehicle for cash management and financing of governments' essential short-term needs.

On June 5, 2013, the Securities and Exchange Commission ("Commission") approved proposed rules for MMMF reform ("Proposal"), which include the option of requiring a floating net asset value ("NAV") for institutional prime and tax-exempt funds. We remain concerned about the impact of a floating NAV on our use of MMMFs for cash management and on these funds' ability to provide municipal financing.

Forcing MMMFs to float their NAVs will create significant accounting, operational, and tax problems for investors and issuers. While we appreciate that the Commission acknowledges these problems, the Proposal provides no clear-cut solutions. Accordingly, we believe that it is incumbent upon the Commission to work jointly with other bodies and interested stakeholders to make certain that accounting, tax, and operational implications are fully addressed before the Proposal is finalized.

As a next step, we therefore request that the Commission convene a roundtable to discuss the issues that the Proposal—and particularly the option of requiring floating NAVs—raises for states and municipal governments, financing authorities, businesses, and others who rely on MMMFs for cash management and short-term financing.

Such a roundtable would afford the Commission and accounting and tax authorities an opportunity to collectively address the complicated repercussions of requiring MMMFs to float the NAV. Significant changes to investment policies, processes, and systems—including in many cases changes to state law—will be required to implement this alternative. The Proposal concedes as much, noting that the move to a floating NAV will necessitate complex and potentially costly changes to numerous financial and accounting systems. A roundtable would inform the Commission on the concerns of government finance

officials and the extent to which they may stop using MMMFs if unworkable regulations are implemented.

A floating NAV requirement for a broad category of MMMFs could also adversely affect states' ability to run local government investment pools ("LGIPs"). Many of these pools model their portfolio management on the risk-limiting provisions of SEC Rule 2a-7 in order to offer a stable $1.00 share price. Changes to Rule 2a-7 that require a broad category of MMMFs to float their share prices could undermine the ability of LGIPs to provide cost-effective cash management for local governmental entities.

Given the many questions raised in the Proposal, we believe that convening a roundtable and continuing the dialogue with interested parties will aid the Commission in generating a more informed, effective rule. Such an approach will ensure that any potential regulatory changes aimed at MMMF reform will be consistent with the Commission's statutory responsibility to promote efficiency, competition, and capital formation. We appreciate the opportunity to continue working with the Commission on MMMF reform, and we would welcome the opportunity to discuss the logistical aspects of a roundtable, including prospective participants, in greater detail.

Sincerely,

Government Finance Officers Association, Dustin McDonald, (202) 393-0208
International City/County Management Association, Beth Kellar, (202) 289-4262
National Association of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou, (202) 624-5451
National Association of State Treasurers, Peter Barrett, (202) 624-8592
National League of Cities, Lars Etzkorn, (202) 626-3173
National Association of Counties, Mike Belarmino, (202) 942-4254
U.S. Conference of Mayors, Larry Jones, (202) 861-6709
American Public Power Association, John Godfrey, (202) 467-2929
Council on Infrastructure Financing Authorities, Rick Farrell, (202) 547-1866

**Government Finance Officers Association**
**National Association of State Auditors, Comptrollers and Treasurers**
**National Association of State Treasurers**
**American Public Power Association**
**Council of Infrastructure Financing Authorities**
**International City/County Management Association**
**International Municipal Lawyers Association**
**National Association of Counties**
**National Association of Health and Educational Facilities Finance Authorities**
**National Association of Local Housing Finance Agencies**
**National Council of State Housing Agencies**
**National League of Cities**
**U.S. Conference of Mayors**

February 13, 2013

Amias Gerety
Deputy Assistant Secretary
Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, DC 20220

**DOC ID: FSOC-2012-0003-0058**

Dear Assistant Secretary Gerety:

Thank you for the opportunity to comment on the Financial Stability Oversight Council's Proposed Recommendations regarding Money Market Mutual Fund Reforms. The organizations listed above representing state and local governments and authorities have serious concerns related to the proposed changes to the structure of money market mutual funds (MMMFs), due to our roles as investors in these products and as issuers of municipal securities that are purchased by these funds. While we have supported and continue to support initiatives that both strengthen money market funds and ensure that investors are investing in high-quality securities, we would like to voice our concerns about some of the Council's suggestions to alter the structure of these funds, especially the proposal to require money market funds to use a floating net asset value (NAV) rather than the current stable net asset value. When similar proposals were circulated at the SEC, we opposed them and our concerns remain.

It is also important to note that states invest in MMMFs for a variety of reasons both for themselves as an investment tool (as do local governments), and in their role managing local government investment pools (LGIPs). If the SEC rules are changed to adopt a daily floating NAV, states would have to alter their own statutes in order to comply, as many state statues cite Rule 2a-7 as the model for their management of the LGIPs. Such a change would introduce a complex set of difficulties in terms of daily accounting that neither the states nor their investors (local governments) are readily equipped to handle.

The fixed NAV is a fundamental feature of money market mutual funds. As investors, many state and local governments look to MMMFs as part of their cash management practice. In the Government Finance Officers Association's Best Practice, "Use of Various Types of Mutual Funds by Public Cash Managers," governments are encouraged to look to money market funds for short-and medium-term investments, with appropriate cautions. One of the critical reasons for this recommendation is the fixed NAV feature found in these products. In fact, many governments have specific policies that mandate that they invest in products with stable values. These requirements and the popularity of MMMFs as a cash management tool reflect the fact that these funds are highly regulated, have minimal risk, and are easily booked by the investor. State and local governments currently have $127 billion invested in these funds according to the Federal Reserve Bank.

Additionally, changing the fundamental feature of MMMFs from a fixed NAV to a floating NAV would dampen investor demand for municipal securities and therefore could deprive state and local governments and other borrowers of much-needed capital. Consider that MMMFs are the largest investor in short-term municipal bonds, holding 73% of all outstanding short-term bonds equaling nearly $271 billion.[1] Creating a marketplace where the NAV changes from fixed to floating would make MMMFs far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt issuance costs for many state and local governments across the country.

In 2010, the SEC reinforced the regulations covering money market mutual funds. We believe that further regulations involving the adoption of a floating NAV would cause many of our members to divest a significant percentage of their investments in MMMFs. Our members would then have to look at competing products that, in turn, could be more susceptible to market conditions, more difficult to account for and manage, more likely to pose greater market risks, and would be more expensive, increasing the costs and fees associated with investing. Furthermore, our members have found that commercial banks do not want to take large investments from state and local governments, because the cost of collateralization over the FDIC limit is too high.

To avoid these negative consequences, we believe that any further money market fund reforms must not involve eliminating this fundamental feature.

The FSOC proposals also ask whether any of the suggested further reforms, if ultimately deemed necessary, should exempt particular types of MMMFs, including those funds investing in state and local government securities.[2] While an exemption may help investors in tax-exempt municipal MMMFs, and therefore lessen the chance that these funds would shy away from purchasing municipal securities, this approach would not assist state and local governments that use MMMFs (including prime MMMFs[3]) for cash management and investment purposes. If the MMMFs that are available for state and local governments to purchase are to be saddled with a floating NAV feature, state and local governments would still be likely to refrain from purchasing these funds, and would have to turn to less safe, less liquid, and less desirable financing options.

If you have any questions about our comments, please contact Dustin McDonald, Director of the Government Finance Officers Association's Federal Liaison Center at 202-393-0208.

Thank you for considering our concerns.

Sincerely,
American Public Power Association, John Godfrey
Council of Infrastructure Financing Authorities, Rick Farrell
Government Finance Officers Association, Dustin McDonald
International City/County Management Association, Beth Kellar
International Municipal Lawyers Association, Chuck Thompson
National Association of Counties, Mike Belarmino
National Association of Health and Educational Facilities Finance Authorities, Chuck Samuels
National Association of Local Housing Finance Agencies, John Murphy
National Association of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou
National Association of State Treasurers, Peter Barrett
National Council of State Housing Agencies, Garth Rieman
National League of Cities, Lars Etzkorn
U.S. Conference of Mayors, Larry Jones

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[1] Investment Company Institute and Bloomberg.
[2] The Proposals discuss three alternative reforms: floating NAV (Alternative One); a "minimum balance at risk" paired with a small capital buffer (Alternative Two); and larger capital buffers, perhaps paired with other risk-limiting regulations (Alternative Three).
[3] Prime MMMFs are taxable MMMFs that may invest in commercial paper and certificates of deposit issued by financial and non-financial businesses, as well as Treasury and government-agency securities.

**American Public Power Association**
**Council of Development Finance Agencies**
**Council of Infrastructure Financing Authorities**
**Government Finance Officers Association**
**International City/County Management Association**
**International Municipal Lawyers Association**
**National Association of Counties**
**National Association of Local Housing Financing Agencies**
**National Association of State Auditors, Comptrollers and Treasurers**
**National Association of State Treasurers**
**National League of Cities**
**U.S. Conference of Mayors**

June 23, 2011

The Honorable Scott Garrett
Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2344 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett and Ranking Member Waters:

We are pleased that the Capital Markets and Government Sponsored Enterprises Subcommittee is holding this hearing to look at the mutual funds market. We are particularly interested in money market mutual funds (MMMFs), due to our role as investors in these products, as well as issuers of municipal securities which are purchased by these funds. The state and local government groups listed above support initiatives that both strengthen money market funds and that ensure investors are investing in high-quality securities. However, we would like to voice our concerns about suggested changes to the structure of these funds, especially any changes from a stable to a floating net asset value (NAV).

Changing MMMFs from a fixed NAV to a floating NAV would dampen investor demand for the securities we offer and deprive state and local governments of much-needed capital. The fixed NAV is the fundamental feature of money market funds. Consider that MMMFs are the largest investor in short-term municipal bonds, holding 56% of all outstanding short-term bonds equaling nearly $352 billion.[i] Creating a marketplace where the NAV changes from fixed to floating would make MMMFs far less attractive to investors, thereby limiting the ability of money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt issuance costs for many state and local governments across the country.

Additionally, as investors, many state and local governments look to MMMFs as part of their cash management practice. In the Government Finance Officer Association Best Practice, "Use of Various Types of Mutual Funds by Public Cash Managers," governments are encouraged to look to money market funds for short-term investments, with appropriate cautions. One of the critical reasons for this recommendation is the fixed NAV found in these products. In fact, many governments have specific policies that mandate stable values, and money market funds are to be used for their short-term investments due to the fixed NAV. Furthermore, MMMFs are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked.

If the Securities and Exchange Commission were to adopt a floating NAV, the organizations listed above expect that many, if not all, of their members would divest a significant percentage of their investments in MMMFs and would have to look at competing products that, in turn, could be more susceptible to market conditions, more difficult to account for and manage, more likely to pose greater market risks, and more expensive, increasing the costs and fees associated with investing.

To avoid these negative consequences, we believe that any money market fund reforms must refrain from eliminating this fundamental feature.

Thank you for considering our concerns and for holding this hearing on mutual funds.

Sincerely,

American Public Power Association, Amy Hille, 202-467-2929
Council of Development Finance Agencies, Toby Rittner, 614-224-1300
Council of Infrastructure Financing Authorities, Rick Farrell, 202-547-1866
Government Finance Officers Association, Susan Gaffney, 202-393-8468
International City/County Management Association, Beth Kellar, 202-289-4262
International Municipal Lawyers Association, Chuck Thompson, 202-466-5424 x7110
National Association of Counties, Mike Belarimo, 202-942-4254
National Association of Local Housing Financing Agencies, John Murphy, 202-367-1197
National Assn. of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou, 202-624-5451
National Association of State Treasurers, Kevin Johnson, 202-624-8592
National League of Cities, Lars Etzkorn, 202-626-3173
U.S. Conference of Mayors, Larry Jones, 202-861-6709

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[i] Investment Company Institute, letter to SEC, January 10, 2011, page 16.

**American Public Power Association**
**Council of Development Finance Agencies**
**Council of Infrastructure Financing Authorities**
**Government Finance Officers Association**
**International City/County Managers Association**
**International Municipal Lawyers Association**
**National Association of Counties**
**National Association of Local Housing Financing Agencies**
**National Association of State Auditors, Comptrollers and Treasurers**
**National Association of State Treasurers**
**National League of Cities**
**U.S. Conference of Mayors**

January 10, 2011

Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F St., N.E.
Washington, DC 20549-1090

Re: Request for Comment on the President's Working Group Report on Money Market Fund Reform (Release No. IC-29497; File No. 4-619)

Dear Ms. Murphy,

The organizations listed above are pleased to comment on the SEC's consideration of the President's Working Group on Financial Markets report, specifically on possible money market reforms, entitled Money Market Fund Reform Options. As we have stated in previous comments to the SEC, notably to proposed changes to SEC Rule 2a-7 in 2009, we support initiatives to strengthen money market funds and ensure that investors are investing in high-quality securities. However, as investors in money market mutual funds (MMMFs), we are concerned about any changes that would alter the nature of these products and eliminate or impede our ability to purchase these securities. In our additional role as issuers of municipal bonds, we are concerned that such changes would dampen investor demand for the securities we offer and deprive state and local governments of much-needed capital.

We are particularly concerned with the issue of whether the SEC should propose or adopt a rule that would change the fixed net asset value (NAV) – the hallmark of money market funds – to a floating net asset value. We believe that such a move would be harmful to state and local governments and the entire MMMF market. The fixed NAV is the fundamental feature of money market funds, and changing its structure likely would eliminate the market for these

products by forcing state and local governments, along with many other institutional investors, to divest their MMMF holdings.

Shrinking the market for MMMFs, in turn, would have severe consequences for state and local finances. MMMFs are the largest investor in short-term municipal bonds, holding 65% of all outstanding short-term bonds equaling nearly $500 billion.[1] Changing the NAV from fixed to floating would make MMMFs far less attractive to investors, thereby limiting the availability for money market funds to purchase municipal securities. Losing this vital investing power could lead to higher debt issuance costs for many state and local governments across the country. Forcing money market funds to float their NAV could thus deprive state and local governments of much-needed capital.

As investors, many state and local governments look to MMMFs as part of their cash management practice. In the Government Finance Officer Association Best Practice, "Use of Various Types of Mutual Funds by Public Cash Managers," governments are encouraged to look to money market funds for short-term investments, with appropriate cautions. One of the critical reasons for this recommendation is the fixed NAV found in these products. In fact, many governments have specific policies that mandate stable values, and money market funds are to be used for their short-term investments due to the fixed NAV. MMMFs are a popular cash management tool because they are highly regulated, have minimal risk, and are easily booked. If the SEC were to adopt a floating NAV for MMMFs, the organizations listed above expect that many, if not all, of their members would divest a significant percentage of their MMMFs and would have to look at competing products that, in turn, could be more susceptible to market conditions, more difficult to account for and manage, and may pose market risk.

Therefore, in considering the options presented in the President's Working Group on Financial Markets report, we recommend that the SEC and the Financial Stability Oversight Council (FSOC) be cognizant of the potential negative effects on state and local governments of any proposals that would fundamentally alter money market mutual funds, in particular those that would directly or indirectly force these funds to float their NAVs. If the Commission or the FSOC does plan to advance the idea of a floating NAV, we request that they provide a hearing and formal proposal of rules for comment and thorough discussion.

Thank you for the opportunity to comment on the SEC's consideration of the recommendations made in the President's Working Group on Financial Markets report on money market fund reform. If you have any questions about this letter, please contact Susan Gaffney, Director of the Government Finance Officers Association's Federal Liaison Center at 202-393-8468.

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[1] Report of the Money Market Working Group, Investment Company Institute, March 2009, pages 18-19.

Sincerely,

American Public Power Association
Council of Development Finance Agencies, Toby Rittner
Council of Infrastructure Financing Authorities, Rick Farrell
Government Finance Officers Association, Susan Gaffney
International City/County Managers Association, Beth Kellar
International Municipal Lawyers Association, Chuck Thompson
National Association of Counties, Mike Belarmino
National Association of Local Housing Financing Agencies, John Murphy
National Association of State Auditors, Comptrollers and Treasurers, Cornelia Chebinou
National Association of State Treasurers, Jim Currie
National League of Cities, Lars Etzkorn
U.S. Conference of Mayors, Larry Jones

**TESTIMONY OF**

**PAUL SCHOTT STEVENS**
**PRESIDENT AND CEO**
**INVESTMENT COMPANY INSTITUTE**

**BEFORE THE**

**SUBCOMMITTEE ON CAPITAL MARKETS AND**

**GOVERNMENT SPONSORED ENTERPRISES**

**COMMITTEE ON FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**ON**

**"EXAMINING THE SEC'S MONEY MARKET FUND RULE PROPOSAL"**

**SEPTEMBER 18, 2013**

## I. Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of $15.3 trillion and serve over 90 million shareholders.

I very much appreciate the opportunity to appear before the Capital Markets and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee and offer our perspectives on the Securities and Exchange Commission's pending rule proposals on money market funds.[1] Money market funds, which date back to the early 1970s, are one of the most significant and successful financial product innovations of the past half century. Today, over 61 million retail investors, as well as corporations, municipalities, and other institutional investors, rely on the $2.6 trillion money market fund industry for a low-cost, efficient cash management tool that provides a high degree of liquidity, stability of principal value, and a market-based yield. Money market funds also serve as an important source of direct financing for state and local governments, businesses, and financial institutions, and of indirect financing for households. Without these funds, financing for all of these institutions and individuals would be more expensive and less efficient.

Money market funds owe their success, in large part, to the stringent regulatory requirements to which they are subject under the federal securities laws including, most notably, Rule 2a-7 under the Investment Company Act of 1940. The regulatory regime established by Rule 2a-7 has proven to be flexible and effective in protecting investors' interests and maintaining their confidence in money market funds. The SEC deserves tremendous credit for crafting these requirements and administering them in a manner that has allowed money market funds to thrive and to serve so many investors. The SEC also has modernized and strengthened the rule from time to time as circumstances warranted—most recently, and very significantly, in 2010. Indeed, it is the SEC's deep and extensive experience that best positions it to consider and implement any further reforms to money market funds.

In recognition of the importance of money market funds to the global economy and to investors, ICI and its members have devoted significant time and effort to considering how to make money market funds more robust under even the most adverse market conditions— such as the serious liquidity challenges arising in 2007-2008 related mainly to rising concerns about U.S. mortgage credit quality and the difficulty in determining the value of mortgage-related assets. These concerns created uncertainty about the balance-sheet strength of large banks and non-bank financial institutions and ultimately led these institutions to become wary of lending to one another, even on a short-term basis.

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[1] *See Money Market Fund Reform; Amendments to Form PF*, SEC Release No. IC-30551 (June 5, 2013), 78 FR 36834 (June 19. 2013) ("Release"), available at http://www.sec.gov/rules/proposed/2013/33-9408.pdf. Pages referenced in this testimony are to the version of the Release on the SEC's website.

Since 2008, the SEC and the fund industry have made a great deal of progress toward their shared goal of strengthening the resiliency of money market funds. Taking the initiative to respond quickly and aggressively to the events of fall 2008, ICI formed a Money Market Working Group to study the money market, money market funds and other participants in the money market, and recent market circumstances. The March 2009 *Report of the Money Market Working Group* ("MMWG Report") addressed these topics and advanced wide-ranging recommendations for the SEC to strengthen money market fund regulation.[2]

In 2010, with the industry's strong support, the SEC approved far-reaching rule amendments that incorporated many of the MMWG Report's recommendations and enhanced an already-strict regime of money market fund regulation.[3] The amended rules have made money market funds more resilient by, among other things, imposing tighter credit quality, maturity, and liquidity standards and increasing the transparency of these funds. The amended rules also provided for an orderly liquidation process in the event that a money market fund proves unable to maintain a stable $1.00 net asset value ("NAV")—an ability that was not available to the Reserve Fund or any other money market fund during the crisis. The 2010 reforms proved their value in 2011 when money market funds—without incident—met large volumes of shareholder redemptions during periods of significant market turmoil, including a credit event involving the historic downgrade of U.S. government debt. Indeed, so far-reaching were these reforms that today's money market fund industry is dramatically different from that of 2008. These reforms were studied by the SEC staff and their findings generally support our views as to the reforms' efficacy.[4] Yet, the calls for further reform continue.

For our part, ICI consistently has supported exploring reasonable options to make money market funds even more resilient while preserving the fundamental characteristics of these funds that are critical to investors. While we continue to believe that the reforms already adopted by the SEC are sufficient, we understand that regulators do not all share that view.

## II. The SEC's Proposals

We remain committed to working with the SEC on this important issue, but we submit that this process should be guided by two principles. First, we should preserve to the greatest extent possible those key features of money market funds that have made them so valuable and attractive to investors.

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[2] *See* Investment Company Institute, *Report of the Money Market Working Group* (March 17, 2009), available at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[3] *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010).

[4] *See* SEC Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (November 30, 2012), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

Second, we should preserve choice for investors by ensuring a continued robust and competitive global money market fund industry.

With these goals in mind, we are particularly supportive of the SEC's decision not to pursue proposals that would require money market funds or their advisers to maintain capital against fund losses (also known as NAV buffers) and/or implement a "minimum balance at risk." These concepts are deeply flawed. The likeliest impact of a NAV buffer requirement would be to impel money market fund sponsors to exit the business, thus depriving investors, issuers, and the economy of the benefits these funds provide. Indeed, the SEC itself acknowledged that the significant ongoing costs associated with a NAV buffer would directly affect money market fund sponsors or investors and indirectly harm capital formation. The minimum balance at risk also has a number of serious drawbacks. Not only would it constantly restrict some portion of an investor's holdings without regard to the fund's circumstances at the time of redemption, but also it would impose significant operational costs on fund complexes, intermediaries, and service providers. Citing these concerns, the SEC notes that a "[minimum balance at risk] coupled with a NAV buffer would turn money market funds into a more complex instrument whose valuation may become more difficult for investors to understand."[5]

Instead, the SEC is considering two reform alternatives that could be adopted either alone or in combination: (i) require prime and tax-exempt institutional money market funds to "float" their net asset values ("floating NAV proposal"); or (ii) require all non-governmental money market funds to impose liquidity fees of up to 2 percent and to have the option to temporarily suspend redemptions (or "gate" the fund) upon the occurrence of specified events indicating that the fund may be under stress ("liquidity fee/temporary gate proposal").[6]

In the course of our discussions of these proposals with ICI members, and members' discussions with fund shareholders, one thing became abundantly clear: shareholders continue to value the stability of principal and ready liquidity provided by money market funds. When pressed to choose one or the other of the proposals put forth by the SEC, however, it appears that some investors place a higher premium on principal stability, while others more heavily value ready access to liquidity. To a great extent, these differing investor perspectives reflect the circumstances and characteristics of the wide range of investors that our member firms serve. It is quite certain, therefore, that combining the SEC's two proposals would devastate the industry, rendering money market funds entirely unattractive to investors.

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[5] Release, *supra* note 1.

[6] The SEC's proposal also includes a number of less fundamental, yet significant, reforms that would apply under either proposal. These include enhanced disclosure and reporting requirements; more stringent diversification requirements; enhanced stress testing; and improved private liquidity fund reporting.

On September 17, ICI submitted a comprehensive comment letter to the SEC on its money market fund reform proposals.[7] Our views on the key elements of the proposal are briefly described below.

### A. No Basis for Fundamental Structural Reforms to Government and Tax-Exempt Money Market Funds

The Release proposes to exempt government money market funds from further structural reform because of, among other things, the following: government money market funds are not susceptible to the risks of mass investor redemptions; their securities have low default risk and are highly liquid in even the most stressful market scenarios; and interest rate risk is generally mitigated because government funds typically hold assets that have short maturities and hold those assets to maturity.[8] We agree with the SEC that no case can be made for applying fundamental changes to government money market funds. We strongly believe that such changes likewise should not apply to tax-exempt funds, for similar reasons.

There is no evidence that investors in tax-exempt money market funds redeem *en masse* during periods of market stress. Moreover, in the unlikely event that tax-exempt money market funds did in fact face widespread redemptions, these funds hold the great majority of their assets in highly liquid securities that can be sold to meet redemptions. Additionally, because of these securities' structures, they are likely more immune to credit deterioration. Consequently, tax-exempt funds, like government funds, should be exempt from both the floating NAV proposal and the liquidity fee/temporary gate proposal. Our comment letter supports this position with data from three events: recent developments surrounding the City of Detroit, Michigan's 2013 bankruptcy; the financial crisis month of September 2008; and the default of Orange County, California in 1994.[9]

[7] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission (September 17, 2013) ("ICI Comment Letter"), available after September 17, 2013 at http://www.ici.org/pdf/13_ici_mmf_ltr.pdf.

[8] *See* Release, *supra* note 1, at 66.

[9] *See* ICI Comment Letter, *supra* note 7.

Moreover, a fundamental restructuring of tax-exempt funds could compromise the critical role that these funds play in providing affordable short-term funding for state and local entities across the United States. Tax-exempt money market funds are the largest investors in short-term municipal debt, holding $252.7 billion as of June 30, 2013. This was almost two-thirds of state and local short-term debt (64 percent as of June 2013). Requiring tax-exempt money market funds to restructure themselves to accommodate a floating NAV could be highly disruptive to their investors and the short-term tax-exempt debt markets.

Voicing these very concerns, a wide range of state and local government entities have argued that a floating NAV would destroy the convenience and simplicity of tax-exempt money market funds for investors, and compromise an important source of financing for many state and local governments.[10] Indeed, the United States Conference of Mayors recently unanimously adopted a resolution that expresses opposition to the floating NAV proposal, stating that "[f]orcing [money market funds] to float their value would likely eliminate the market for those products by forcing investors, including state and local governments, to divest their [money market fund] holdings as well as discourage others from using these funds."[11] Members of Congress also have shared their concerns regarding how new regulations on money market funds would impact municipalities' costs of borrowing.[12]

### B. Liquidity Fee/Temporary Gate Proposal

The SEC's liquidity fee/temporary gate proposal—*i.e.,* allowing money market funds to continue to transact at a stable share price under normal market conditions, but under certain circumstances when a fund may be stressed from a liquidity standpoint (i) requiring the fund to institute a liquidity fee designed to deter further redemptions and (ii) permitting the fund to temporarily suspend redemptions—has the support of various of our members because it promises to slow or stop significant fund outflows. These tools, together with enhanced disclosure, directly address regulators' concerns about redemption pressures on prime money market funds.

Under the liquidity fee/temporary gate proposal, if a money market fund's level of "weekly liquid assets" were to fall below 15 percent of its total assets (half the required amount) after the close of

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[10] For examples of governments, government officials, and organizations that have voiced support for maintaining the stable NAV for tax-exempt money market funds, *see* http://www.preservemoneymarketfunds.org/what-others-are-saying/.

[11] See Letter from Scott Smith, Mayor of Mesa, President, The United States Conference of Mayors, to Mary Jo White, Chairman, Securities and Exchange Commission (July 18, 2013), available at http://www.sec.gov/comments/s7-03-13/s70313-30.pdf.

[12] For example, during a hearing by the House Committee on Financial Services on the SEC's FY 2014 budget request, Representative Michael G. Fitzpatrick (R-PA) noted to SEC Chair Mary Jo White the importance of money market funds to municipalities. "[B]efore I came to Congress, I was a local elected official in Bucks County, [PA] . . .and a lot of local officials and state officials rely on money market funds as a source of sort of cash management. It's an important tool to have in the toolbox." *See Oversight of the SEC's Agenda, Operations, and FY 2014 Budget Request,* Hearing before the House Committee on Financial Services (May 16, 2013), available at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=333327.

business, the money market fund would automatically impose a liquidity fee in connection with redemptions received for processing the next business day. The nonrefundable liquidity fee, which would be equal to 2 percent of redemption proceeds, would be paid to the fund by redeeming shareholders. A 2 percent liquidity fee would not be imposed, however, if the fund's board of directors determines that the fee is not in the best interest of the fund or that a lesser liquidity fee is in the best interest of the fund.

Once a money market fund's weekly liquid assets fell below 15 percent of total assets, its board of directors also would be permitted to impose a temporary gate. A money market fund that suspends redemptions would need to restore the right to redeem within 30 days, although the board of directors could determine to restore it earlier. Money market funds would not be able to suspend redemptions for more than 30 days in any 90-day period.

The SEC explains that the liquidity fee/temporary gate proposal is designed to address the contagion effects of heavy redemptions in money market funds that had a significant impact on investors, funds, and the markets during the financial crisis. Regardless of the incentives to redeem, the Release notes that a liquidity fee would make redeeming investors pay for the costs of liquidity and, if investors continued to redeem from a fund, temporary restrictions on redemptions would directly halt a run.

To make these tools even more useful to fund boards, our comment letter recommends that the SEC expand the circumstances under which a board may impose a liquidity fee or temporarily suspend redemptions to cover situations when heavy redemptions are already underway or are clearly foreseeable.

Notwithstanding the support for the liquidity fee/temporary gate proposal, it has potential drawbacks. It is unclear how many investors would use a money market fund with liquidity fees and gates given the explicit possibility of restricted liquidity, what impact this measure would have on certain transaction types; and what tax implications a liquidity fee might have for money market funds and their shareholders. There is no question that complex and costly system modifications by fund transfer agents and intermediaries would be necessary to handle liquidity fees and temporary gates. We anticipate that it may take at least three years to allow the industry to complete the operational and other changes necessary to successfully implement liquidity fees and temporary gates.

### C. Floating NAV Proposal

The SEC's other proposed approach would fundamentally alter prime and tax-exempt institutional money market funds by requiring these funds to have a floating NAV instead of a stable NAV. Specifically, these funds would be required to sell and redeem shares based on the current market-based value of the securities in their underlying portfolios and "basis point round" their share price to the nearest 1/100th of one percent (*e.g.*, the fourth decimal place in the case of a fund with a $1.0000 share price). The Release indicates that the floating NAV proposal is designed primarily to

address the incentive of money market fund shareholders to redeem shares in times of fund and market stress based on the fund's valuation and pricing methods, and to improve the transparency of pricing associated with money market funds.

ICI has maintained consistently since 2009 that forcing funds to float their NAVs would not achieve such goals. Even assuming that investors are willing to use floating NAV money market funds, a floating NAV is unlikely to alter meaningfully investors' behavior during a market crisis. On the contrary, there is considerable evidence, as the SEC itself acknowledges, that the outflows from prime money market funds during September 2008 were part and parcel of a flight by investors to the quality and liquidity of the Treasury market. Indeed, there is evidence, as the SEC also acknowledges, that long-term funds (whose NAVs have always floated) experienced significant outflows during the financial crisis.

1. **Loss of Key Benefits Valued by Investors**

The floating NAV proposal would require funds, intermediaries and investors to make very significant and costly operational changes to accommodate floating NAV money market funds. Forcing money market funds to float their NAVs would impose significant tax burdens on funds and investors. Unlike investors in stable NAV money market funds, those in floating NAV money market funds could have taxable gains and losses upon every redemption. Even though those gains and losses likely would be very small, they would be subject to tax reporting. This means that funds, intermediaries, and most institutional investors would have to build new or expand existing systems to track, calculate and report gains and losses, at a significant cost. It bears emphasizing, contrary to some media commentary, these changes would be onerous because, among other things, the volume and frequency of transactions in money market funds makes this reporting exponentially more difficult than it is for other floating NAV mutual funds. The Treasury Department and the Internal Revenue Service have suggested measures to mitigate these burdens; however, their suggested *de minimis* exceptions and simplified reporting schemes do not go far enough and in some cases may exacerbate the problems. We are discussing these concerns with the Treasury Department and the IRS. Congressional action may be necessary, however, if regulatory solutions are not possible or are inadequate.

Requiring floating NAVs also complicates the accounting treatment of money market funds and could result in the loss of same-day settlement services, which are extremely important to institutional investors managing their daily cash. Moreover, the product would be unusable as a sweep vehicle. Without these benefits, widespread investor acceptance of a floating NAV money market fund product is unlikely. It is critical, therefore, that the changes necessary to alleviate these tax and accounting burdens be implemented *before* any floating NAV requirement takes effect.

### 2. Reduction in Capital Market Funding

One clearly foreseeable impact of the floating NAV proposal is a reduction in capital market funding to the private sector. Requiring prime institutional money market funds to float their NAVs risks precipitating an outflow of hundreds of billions of dollars from prime money market funds to other products, including government money market funds. This could result in a major restructuring and reordering of intermediation in the short-term credit markets, and the transition is likely to be highly disruptive. Regulatory changes that push assets from money market funds toward other money market instruments and uninsured bank deposits would disrupt the capital markets and fail in the long run to address the concerns the SEC has raised, such as promoting safer capital markets and reducing risks to the economy at large. It also is not clear that regulatory policies that further concentrate deposits in the largest banks reduce systemic risks.

### 3. Disclosure Achieves Same Goals

The SEC itself questions whether a floating NAV would help limit widespread redemptions, focusing instead on the potential ability of a floating NAV to heighten investors' awareness that these funds hold securities whose market values fluctuate. If this is the goal, it could be achieved more simply and at less cost by requiring these funds to publish their daily mark-to-market values.

Regulators might argue that such costs are justified by the benefits of reducing risks to the financial system. Because the operational changes required are so extensive, difficult and costly to make, many sponsors, intermediaries, and institutional investors will not make them, potentially resulting in increased assets in unregulated products or a risky buildup of uninsured deposits in the banking system. These disincentives to offer floating NAV funds would be compounded by additional regulatory requirements. Like all long-term funds, prime and tax-exempt institutional money market funds would have to float their NAVs but, unlike long-term funds, these funds would still be required to adhere to Rule 2a-7 *and* a proposed pricing standard that is 10 times more stringent than the pricing standard for other floating NAV products.

### 4. Retail Fund Exception

If the SEC nevertheless determines, despite our longstanding concerns, to require funds to float their NAVs, we agree that the reach of that action should be reasonably tailored and that it is appropriate to exempt "retail" funds from the floating NAV requirement. Money market funds provide retail investors access to investments not otherwise affordable or accessible, such as commercial paper issued in minimum denominations beyond the reach of the average investor. Maintaining the availability of prime stable NAV money market funds for retail investors, therefore, is particularly important because those funds provide diversification and a market-based rate of return that is not otherwise available through a bank deposit account.

We have significant concerns, however, that the SEC's proposal to define retail funds through a redemption limit would impair investor liquidity and be more onerous operationally than other methods. Instead, we recommend using a social security number ("SSN") as the fundamental characteristic to identify an investor eligible to invest in a retail money market fund. Under this recommended approach, any account opened by a fund or intermediary that has captured an SSN as a (tax) identification component for the registered owner or beneficial owner of an account would qualify for investment in a stable NAV retail money market fund. This approach would capture a very large percentage of the retail investors who invest in money market funds directly. It also would include accounts whose underlying beneficiaries have an SSN, such as those invested in tax-advantaged savings accounts, retail brokerage, and certain trust accounts whose beneficiaries have SSNs that are held in the name of intermediaries on fund transfer agent records. Importantly, using SSNs would be far less costly to implement than other methods of defining retail funds, including the SEC's proposed daily redemption limit.

Finally, regulators should be concerned that the transition from stable to floating NAV could be destabilizing to the financial markets because it could require money market funds to potentially shed hundreds of billions of dollars of money market instruments as their investors redeem in favor of other products. If the SEC's proposed changes are adopted, mitigating transitional impacts to shareholders must be a primary goal for regulators. With all that needs to be considered and accomplished by funds, intermediaries, and investors, the industry needs a significant transition period with a compliance date of the later of at least 3 years following issuance of final SEC rules; or January 1 of the calendar year that begins at least 12 months after final tax guidance is issued or, if needed, new legislation has been passed.

### D. Potential Combination of Floating NAV and Liquidity Fee/Temporary Gate Proposals

The SEC also is considering whether to combine the floating NAV and the liquidity fee/temporary gate proposals into a single reform package. If the proposals are adopted in combination with each other, prime and tax-exempt institutional money market funds would be required to transact at a floating NAV and, in addition, all non-government money market funds would be required to impose liquidity fees (unless waived by the board) and permitted to impose temporary gates in certain circumstances.

*We strongly oppose the combination of these two proposals.* The combination of the two SEC proposals will produce a fund that lacks both the share price stability and the assured redeemability of today's money market fund. The result: a fund that nobody will want because nobody will need. Instead, institutional investors would seek out other cash management investment alternatives that offer principal stability (*e.g.*, government money market funds, investment products not registered under the Investment Company Act such as separate accounts or unregistered cash management pools, or uninsured bank deposits) or that have neither potential restrictions on redemptions nor the yield-limiting restrictions of Rule 2a-7 (*e.g.*, all other mutual funds). Although for cash management

purposes these options are not as ideal as money market funds, for many investors they are far more attractive than a floating NAV fund that also may not always provide ready liquidity. The principal impact of such a combination, therefore, would be to shrink dramatically, perhaps to extinction, the assets of prime and tax-exempt institutional money market funds.

A combination of the floating NAV proposal and the liquidity fee/temporary gate proposal also would undermine the attractiveness of retail money market funds. Under the SEC's proposal, a money market fund would be exempt from the floating NAV requirement if it does not permit a shareholder to redeem more than $1 million per day. It is simply overkill to add additional structural reforms to a fund that already restricts the daily liquidity available to investors.

From an operational standpoint, the combination of the two proposals would be extremely burdensome and cost prohibitive for the industry. Funds, transfer agents, intermediaries, institutional investors and others would incur significant operational costs that include establishing or modifying a wide range of systems and procedures to process transactions at floating NAVs (not to mention the necessary changes to accommodate increased recordkeeping, accounting and tax reporting burdens). Then, in addition, they would incur costs in establishing or modifying systems and related operational changes to administer a liquidity fee and temporary gate.

It is informative to consider the SEC's own estimated costs of its proposals. Using the Release's estimated one-time and ongoing costs[13] to implement the floating NAV and liquidity fee/temporary gate proposals, we estimate the following costs would be incurred:

- Funds and their transfer agent service providers would incur *one-time costs* ranging from approximately $400 to $712 million, and *annual ongoing costs* of approximately $40 to $137 million to implement both proposals. These estimates *do not include* one-time and ongoing costs for intermediaries, institutional investors, or others affected by the proposed changes.

- The cost for the industry (including funds, transfer agents, intermediaries, institutional investors, and service providers) to implement both proposals would be 2 to 2 ½ times the estimated costs for funds, with total *one-time costs* ranging from approximately $800 million to $1.75 billion, and *annual ongoing costs* of approximately $80 to $350 million.

Again, the key issue is not the size of these costs relative to potential benefits of reducing any potential risks that regulators believe money market funds may pose. Instead, the key fact is that these costs are so large that they will encourage the use of less regulated alternatives, an outcome that would not benefit investors, the economy or the financial system.

[13] *See* Release, *supra* note 1, at 107, 126, 129, 203, and 227. In discussions regarding the one-time and ongoing annual costs estimated in the Release, our members have indicated that those cost estimates are low when compared to their own estimates.

E. **Enhanced Disclosure and Reporting**

ICI consistently has supported efforts to increase the public disclosure of money market fund portfolio information and risks, and to enhance the SEC's access to money market fund data. Our support for further disclosure and reporting enhancements turns on whether money market funds are permitted to maintain a stable NAV. We offer our overall support for enhancing the disclosure requirements for stable NAV money market funds. If the SEC requires money market fund NAVs to float, however, the proposed disclosure requirements would be unnecessary and we oppose them. Furthermore, we question the benefit of the current level of money market fund disclosure and reporting—which is far more detailed and frequent than that for any other floating NAV funds—for money market funds that are required to float their NAVs.

We appreciate the opportunity to share our views with the Subcommittee. We remain committed to working with Congress and the SEC as they seek to address this important issue in the best possible way for the millions of American investors who rely on money market funds as an effective cash management tool and as an indispensable source of short-term financing for the U.S. economy.

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September 12, 2013

Securities and Exchange Commission
Attention: Elizabeth M. Murphy
100 F Street, NE
Washington, DC 20549-1090

**Re: Securities and Exchange Commission's Money Market Fund Reform; Amendments to Form PF (the "Proposal"), SEC File No. S7-03-13, 78 FR 36833, June 5, 2013.**

I am writing on behalf of the 12 Federal Reserve Bank Presidents, all of whom are signatories to this comment letter. We appreciate the opportunity to provide comments on the Securities and Exchange Commission's ("SEC") Money Market Fund Reform; Amendments to Form PF release (the "Proposal") issued on June 5, 2013.[1] The SEC took a very important step towards Money Market Mutual Fund ("MMMF") reform by issuing this Proposal, which includes two principal reform alternatives: (i) a floating net asset value per share ("NAV") requirement for prime institutional MMMFs, and (ii) stand-by liquidity fees and temporary redemption gates for non-government MMMFs that breach a pre-determined trigger.[2]

We applaud the SEC Commissioners' and staff's continued efforts in this area. We believe the SEC is well-positioned to implement meaningful reforms that not only better protect investors but also address the risks to financial stability posed by MMMFs. In our previous comment letter to the Financial Stability Oversight Council ("FSOC"), we noted that more than one of the FSOC's proposed alternatives could address these risks.[3] Accordingly, we welcome the inclusion of the floating NAV alternative in the current Proposal. We strongly support this alternative, especially if certain enhancements are undertaken. However, we do not support the stand-by liquidity fees and temporary redemption gates alternative, as these mechanisms do not meaningfully reduce the risks that MMMFs pose to financial stability.

We briefly discuss the risks to financial stability posed by MMMFs, particularly prime MMMFs, in Section I.[4] Section II offers observations on the floating NAV alternative, including several suggestions for increasing its effectiveness. Section III outlines our concerns with the stand-by liquidity fees and temporary redemption gates alternative. Finally, Section IV discusses the proposed enhancements to portfolio disclosure and diversification requirements.

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[1] The views expressed in this letter are ours and do not necessarily reflect those of the Board of Governors of the Federal Reserve System.

[2] On page 69 of the Proposal, the SEC noted that the "retail" exemption from the floating NAV alternative would likely cover most tax-exempt MMMFs, because the tax benefits offered by such funds are "only enjoyed by individuals." On page 198 of the Proposal, the SEC noted that a government MMMF may choose to impose a liquidity fee or temporary redemption gate, if its ability to impose such measures was previously disclosed in its prospectus.

[3] Federal Reserve Bank Presidents' Comment Letter to the FSOC submitted on February 12, 2013. The FSOC proposed three reform alternatives: (i) a floating NAV requirement, (ii) NAV buffer of up to 1 percent and a Minimum Balance at Risk, and (iii) Risk-based NAV buffer of 3 percent and other measures. *See* FSOC, "Proposed Recommendations Regarding Money Market Mutual Fund Reform," November 2012.

[4] Prime MMMFs invest primarily in non-government debt instruments such as commercial paper, certificates of deposit, time deposits, and floating rate instruments. As of June 30, these instruments accounted for approximately 75 percent of prime MMMFs' assets. Based on data from iMoneyNet.

**Section I Risks to Financial Stability Posed by MMMFs**

MMMFs serve an important function in the short-term credit markets by acting as intermediaries between investors seeking a highly liquid, diversified fixed income investment, and a variety of corporate and government entities seeking short-term funding. As a result, disruptions in MMMFs' ability to function as credit intermediaries can have a significant negative impact on the broader financial system.

On numerous occasions over the past few years, government officials and academics have discussed the risks that MMMFs pose to financial stability.[5] These risks were also highlighted in the FSOC's 2013 annual report. As currently structured, MMMFs permit redemptions and purchases at a constant NAV (generally $1.00), take credit risk, and have no mechanism to absorb losses.[6] Investors therefore have an incentive to "run" from a fund when they perceive its market-based NAV to be less than its transaction (or reported) NAV. The risks associated with this structure were evident in September 2008, when investors fled from prime MMMFs into government MMMFs, exacerbating disruptions in the short-term credit markets.[7] The U.S. Government used multiple approaches to restore liquidity to credit markets, some of which targeted MMMFs directly and many of which indirectly helped to restore MMMFs to normal functioning.[8]

In 2010, the SEC amended Rule 2a-7, enacting several new or enhanced requirements aimed at strengthening the stability of MMMFs.[9] Despite these important changes, MMMFs remain a significant risk to financial stability. Indeed, a November 2012 study by SEC staff found that the Commission's 2010 reforms were "not sufficient to address the incentive to redeem when credit losses are expected to cause funds' portfolios to lose value or when the short-term financing markets ... come under stress."[10] As such, we strongly urge the SEC to proceed with additional reforms.

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[5] *See, e.g.,* Eric Rosengren, "Money Market Mutual Funds and Financial Stability," April 2012; William Dudley, "Fixing Wholesale Funding to Build a More Stable Financial System," February 2013; Squam Lake Group, "Reforming Money Market Funds," January 2011; Sheila Bair, "Statement by the Systemic Risk Council on Money Market Fund Reform," July 2012; International Monetary Fund, "April 2013 Global Financial Stability Report," April 2013; Daniel Tarullo, "Financial Stability Regulation," October 2012; Sallie Krawcheck's FSOC Comment Letter; Mary Schapiro, "Remarks at the Financial Stability Oversight Council Meeting," November 2012; Patrick McCabe, Marco Cipriani, Michael Holscher, Antoine Martin, "The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posted by Money Market Funds," July 2012; Henry Paulson's PWG Comment Letter; International Organization of Securities Commissions, "Money Market Fund Systemic Risk Analysis and Reform Options," April 2012.

[6] Different categories of MMMFs take varying levels of credit risk. We focus on prime MMMFs, where the greatest credit risk can be taken and where the risks to financial stability appear to be the greatest. For more on credit risk in prime MMMFs, *See* Eric Rosengren, "Money Market Mutual Funds and Financial Stability," April 2012.

[7] In the week after the Reserve Primary Fund broke the buck on September 15, 2008, investors redeemed approximately $321 billion or 16 percent of assets from prime MMMFs. Based on iMoneyNet data.

[8] The Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF") and Temporary Guarantee Program ("TGP") directly benefitted MMMFs. Other government programs, such as the Commercial Paper Funding Facility ("CPFF"), indirectly benefitted MMMFs. Specifically, the AMLF, announced on September 19, 2008 by the Federal Reserve Board, "...was designed to provide a market for ABCP that MMMFs sought to sell." The CPFF, announced on October 7, 2008 by the Federal Reserve Board, provided a liquidity backstop to domestic issuers of commercial paper. For more on these Federal Reserve Programs, *See* Board of Governors of the Federal Reserve System, Regulatory Reform Facilities and Programs, 2008. The TGP, announced on September 19, 2008 by the U.S. Department of Treasury, guaranteed the NAV per share of eligible MMMFs. For more on the TGP, refer to U.S. Department of Treasury, Treasury Announces Temporary Guarantee Program for Money Market Funds, September 2008.

[9] 2010's amendments to Rule 2a-7 tightened weighted average maturity limits; enacted new Daily Liquid Assets ("DLA"), Weekly Liquid Assets ("WLA"), and weighted average life requirements; enhanced holdings disclosure requirements; introduced new Rule 22e-3, which permits a MMMF to suspend redemptions and postpone payment of proceeds in order to facilitate an orderly liquidation; and introduced "know your customer" and stress testing requirements, among other changes. SEC, "Money Market Reforms; Final Rules," Investment Company Act Release No. IC-29132, May 2010.

[10] Division of Risk, Strategy, and Financial Innovation, "Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher," SEC, November 2012. The quotation is from page 44 of the SEC's Proposal.

### Section II Observations on Alternative 1: Floating NAV Requirement

Under this alternative, prime institutional MMMFs would be required to process purchases and redemptions based on the current market-based value of the securities in their portfolios, rounded to the nearest $1/100^{th}$ of a percent.[11] These funds would continue to be limited to investing in short-term, high quality, dollar denominated instruments. Government and retail MMMFs are exempt from this alternative.

We agree with the SEC's position that a floating NAV requirement, if properly implemented, could recalibrate investors' perceptions of the risks inherent in a fund by "making gains and losses a more regularly observable occurrence."[12] Because a constant NAV MMMF generally draws risk-averse investors, it is likely that given an appropriate transition period, the investor base would either change or become more tolerant of NAV fluctuations, lowering the risk of destabilizing runs. Indeed, a floating NAV fund may actually attract investors seeking a higher yield for their cash investment during times of broad financial market stress.[13]

Further, the floating NAV alternative reduces investors' incentives to redeem by tempering the "cliff effect" associated with a fund "breaking the buck." The first mover advantage is reduced because redemptions would be processed at a NAV reflective of the market-based value of the fund's underlying securities.

### Section II.A Issues to be Addressed to Further Enhance the Floating NAV Alternative

While we are supportive of this alternative, we have identified several issues that should be addressed to further enhance its efficacy.

*Proper Valuation of Money Market Instruments is Critical*

The effectiveness of a floating NAV option depends on funds' ability to properly value money market instruments. To the extent that investors believe that a fund's "true" market-based NAV is below its reported NAV, they will be incented to redeem before other investors.

One often-mentioned challenge to valuing non-government related money market instruments is the infrequency of secondary market transactions for such instruments.[14] Even under the current fixed NAV regime, however, funds are able to value such instruments using a combination of matrix pricing and model-based valuation methodologies.[15] As such, MMMFs subject to the floating NAV requirement would also be able to value their portfolio securities on a daily basis for the purposes of computing a

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[11] As discussed below, MMMFs subject to the floating NAV requirement would be permitted to apply the SEC's 1977 Valuation guidance, under which securities with remaining or final maturities of no more than 60 days can be valued at amortized cost, in circumstances where the amortized cost accurately reflects the securities' fair value, as determined using market factors. *See* Footnote 18.

[12] Page 53 of the Proposal. Separately, as noted in our FSOC Comment Letter (Footnote 3) MMMF sponsor support may reduce investors' awareness of the risks in MMMFs by creating a perception of stability.

[13] As noted in our Comment Letter to the FSOC (Footnote 3). Others have made similar observations, *See, e.g.,* Thrivent Financial's FSOC Comment Letter, in which they argued that a FNAV potentially offers higher returns in a rising rate environment, during times of weak market liquidity, and in the face of credit events.

[14] *See, e.g.,* John Hawke, Jr., "Economic Consequences of Proposals to Require Money Market Mutual Funds to "Float" Their NAV," November 2012;; and Samuel Hanson, David Scharfstein, and Adi Sunderam, "An Evaluation of Money Market Fund Reform Proposals," Harvard University, December 2012.

[15] *See, generally* Footnote 14; Joan Swirsky, "The Guide to Rule 2a-7. A Map Through the Maze for the Money Market Professional," May 2008.

transaction NAV.[16] While the resulting prices may serve as a natural starting point for market-based NAV computations required under this alternative, we encourage the SEC to continue its efforts to increase the transparency of fixed income markets to further enhance price discovery.[17]

MMMFs subject to the floating NAV alternative would be permitted to apply the SEC's 1977 valuation guidance, under which securities with remaining or final maturities of 60 days or less can be valued at amortized cost, in circumstances where the amortized cost accurately reflects the securities' fair value as determined using market factors.[18] Because MMMFs are required to maintain a weighted average maturity of 60 days or less under current rules, it is likely that a fund would be permitted to apply this guidance to a majority of its portfolio assets.[19] As such, any uncertainty in applying the guidance could have a significant impact on a fund's overall valuation. We urge the SEC to continue monitoring funds' procedures for determining that amortized cost accurately reflects fair value, as inappropriate valuation procedures could reduce the efficacy of the floating NAV alternative both in reducing run risk and in recalibrating prime MMMF investors' risk expectations.

*Retail Exemption Poses Challenges*

The SEC proposes to exempt prime retail MMMFs, defined as those with a daily shareholder redemption limit of $1 million or less, from the floating NAV requirement. The SEC supports this exemption by inferring that retail investors are less likely to run during times of financial market stress than institutional investors. While it is true that in aggregate, retail MMMFs did not experience large-scale redemptions during the financial crisis, some individual retail funds did experience redemptions above historical norms during the week that the Reserve Primary Fund broke the buck.[20] Although one may speculate that these heightened redemptions could have become a more widespread run, this possibility was forestalled by Government intervention that supported the MMMF market. Government intervention notwithstanding, some retail MMMF sponsors' actions during the financial crisis suggest that they were concerned about runs. Certain sponsors chose to support their retail MMMFs, presumably to forestall runs that could occur if investors feared that a fund would "break the buck."[21] Also, some retail funds participated in the

[16] Indeed, earlier this year, some large MMMF complexes (voluntarily) began daily reporting of the market-based NAV per share of their MMMFs. *See, e.g.*, announcements from: Goldman Sachs Asset Management; Fidelity Investments; and JP Morgan Asset Management.
[17] As noted in our FSOC Comment Letter (Footnote 3), we agree with those who have pointed out that certain money market instruments lack an active secondary market. However, primary markets may also provide useful information to enhance price discovery. More generally, we encourage the SEC to continue its efforts to enhance transparency in the fixed income markets, inclusive of markets for money market instruments. Recent efforts include the SEC's April 16, 2013 Fixed Income Roundtable, in which a panel discussed "...potential ways to improve the transparency and efficiency of fixed income markets." SEC's Fixed Income Roundtable Release. In addition, the SEC issued a Report on the Municipal Securities Market on July 2012, which provided recommendations for potential consideration aimed at improving the municipal securities market.
[18] SEC, Valuation of Debt Instruments by Money Market Funds and Certain Other Open-End Investment Companies, Investment Company Act Release No. 9786, May 1977.
[19] As of month end June 30, prime MMMFs allocated 55 percent of their portfolios to securities with a final maturity of 60 days or less. Prime institutional MMMFs allocated 56 percent of their portfolios to such securities. Based on data from Crane Data.
[20] Figure 3 from Lawrence Schmidt, Allan Timmermann, and Russ Wermers, "Runs on Money Market Mutual Funds," January 2, 2013. Also, in its FSOC Comment Letter, JP Morgan notes, "Although it is evident that runs are slower to hit retail funds than institutional MM[M]Fs, retail funds are not immune to a run on their assets, and so should be subject to the same regulatory protections."
[21] In reviewing the *direct* (i.e., cash contributions or an outright purchase of distressed securities) sponsor support instances from 2007 to 2010, we find that of the 78 distinct prime MMMFs that received support, no less than 30 were classified as "retail" MMMFs. Based on category classifications reported on iMoneyNet from January 2008 through January 2012. Direct sponsor support instances were obtained from: Steffanie Brady, Ken Anadu, and Nathaniel Cooper, "The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011," Federal Reserve Bank of Boston, August 2012.

AMLF, which was introduced to help MMMFs holding asset-backed commercial paper meet investors' redemption demands.[22]

More broadly, a structural incentive would remain for investors in retail MMMFs that are exempt from the floating NAV requirement to be the first to redeem during times of stress. While retail investors did not *en masse* act on this incentive during the crisis, it seems imprudent to assume that their behavior in the future will be the same as in the past.[23] Accordingly, we find it appropriate that all prime MMMFs, including those characterized as "retail," be subject to the floating NAV requirement.

We are also concerned that the $1 million redemption threshold may not fully exclude institutional investors from retail funds, as services might emerge to spread large cash balances across numerous MMMFs eligible for the retail exemption.[24] The entry of institutional investors into "retail" funds would likely increase the run risk to which the retail investors are exposed.

*Risk Profile of Government MMMFs May Change*

The SEC proposes an exemption to the floating NAV requirement for MMMFs with at least 80 percent of total assets in cash or U.S. government-related securities (including repurchase agreements collateralized by U.S. government-related securities). Although such a threshold is consistent with current rules defining government MMMFs (including Treasury-only MMMFs), we are concerned that using this same threshold for the purposes of a floating NAV exemption may fundamentally alter the actual risk profile of such funds.[25] It is noteworthy that despite the possibility of holding up to 20 percent of their portfolio in non-government-related securities, government MMMFs' actual allocation to such securities was significantly less. Specifically, as of month-end June 2013, each of the ten largest government MMMFs held more than 99 percent of its portfolio in U.S. government-related securities.[26]

Given a new opportunity to attract investors willing to take on credit risk but seeking a stable NAV MMMF, portfolio managers may increase their allocation to non-government-related securities. They may also select individual corporate securities with a higher risk profile – resulting in heightened risk for this class of funds. In order to avoid such unintended consequences, we encourage the SEC to consider more stringent requirements for the "government" exemption. For example, the SEC could consider tightening the diversification requirements for government MMMFs or could increase the minimum percentage of U.S. government-related securities required to claim the exemption.

**Section II.B Some Concerns Associated with a Floating NAV Requirement Abated**

We acknowledge certain concerns raised by industry participants related to this option. However, the design of the actual Proposal as well as recent steps taken by the IRS may have eliminated the most significant of these concerns.

[22] Of the 189 MMMFs that participated in the AMLF, no less than 44 (approximately 23 percent) were classified as retail MMMFs. Based on data from iMoneyNet, SEC filings, and the Federal Reserve Board's List of AMLF participants. The "retail" classification is based on category classifications reported on iMoneyNet from January 2008 through January 2012. Refer to Footnote 8 for more information on the AMLF.
[23] The SEC made a similar observation in page 75 of the Proposal.
[24] The SEC made a similar observation in page 78 of the Proposal. *See, also,* BlackRock's FSOC Comment Letter.
[25] SEC, Investment Company Names; Final Rule, Investment Company Act Release No. IC-24828, March 2001.
[26] The funds reviewed were the 10 largest publicly available government MMMFs, which accounted for approximately 34 percent of total government MMMF assets as of month-end June 2013. Based on data from iMoneyNet, and fund companies' monthly holdings report.

*Tax Consequences Minimized*

Some have voiced concern that under a floating NAV, investors who actively use their MMMFs as a transaction account could incur significant tax compliance burdens related to the tracking of capital gains and losses.[27] However, the Proposal notes that mutual funds that do not transact at a stable NAV (or their intermediaries) are already required to provide information on gains and losses to most shareholders, and these information reporting requirements would extend to floating NAV MMMFs.[28] As most MMMF sponsors also offer other (non-MMMF) mutual funds for which they already perform such tracking, the ability to leverage existing infrastructure would likely reduce the costs of extending such activities to MMMFs.[29] Additionally, the Internal Revenue Service ("IRS") recently prescribed circumstances under which an investor's realized losses from the sale of shares of a floating NAV MMMF would be exempt from the wash-sale rule, thereby minimizing the cost of compliance associated with this rule.[30]

*Government MMMFs Remain an Option for CNAV Investors*

The simplicity afforded by a constant NAV is often cited to suggest that investors may discontinue using MMMFs if the constant NAV feature is eliminated.[31] However, investors preferring a constant NAV MMMF may continue to invest in such vehicles by purchasing shares of government MMMFs, which would not be subject to the floating NAV requirement.[32] For those investors whose investment policy statements ("IPS") prohibit investments in a variable NAV MMMF, the two-year compliance period may provide sufficient time to re-evaluate their cash management needs.[33] Such investors would have the option of either amending their IPS to permit investments in a variable NAV fund or migrating to a fixed-NAV government MMMF.

**Section III Observations on Alternative 2: Liquidity Fees and Temporary Redemption Gates**

Under this alternative, non-government MMMFs would be permitted to "transact at a stable share price under normal market conditions," but would be required to impose a stand-by liquidity fee of no more than two percent[34] on all redemptions if a fund's Weekly Liquid Assets ("WLA") were to fall below 15 percent of total assets, unless the fund's directors (including a majority of the fund's independent directors) determined that such action was not in the best interest of the fund. In addition, the fund's directors (including a majority of the fund's independent directors) may opt to "gate" the fund upon breaching the WLA threshold, if they determine that such action is in the best interest of the fund.

[27] *See, generally,* Treasury Strategies' FSOC Comment Letter; the Investment Company Institute's FSOC Comment Letter; UBS Global Asset Management, Inc.'s FSOC Comment Letter.

[28] Page 117 of the Proposal further notes that the U.S. Treasury Department and the IRS are considering other possible relief such as allowing summary income tax reporting by shareholders. The Proposal also requested comment (page 119) on mutual funds' tax reporting practices for shareholders exempt from information reporting – contemplating whether funds can use existing infrastructure to facilitate such reporting for exempt shareholders in a floating NAV MMMF.

[29] Of the ten largest MMMF sponsors as of year-end 2012, each managed assets in non-2a-7 mutual funds. Others have made similar observations, *for, e.g.,* in its FSOC Comment Letter, Thrivent Financial (*See* Footnote 13) notes: "Non-money market mutual funds must already report the basis and holding period of redeemed shares. Expanding this to cover money market funds will require effort, but the operational apparatus exists."

[30] *See* IRS Notice 2013-48. Some industry participants have noted that such an exemption "would be necessary to retain the operational effectiveness of the product and reduce the cost of compliance," JP Morgan's FSOC Comment Letter, *See* Footnote 20.

[31] *See, generally,* Fidelity Investments' FSOC Comment Letter; U.S. Chamber of Commerce's FSOC Comment Letter; The Greater Pittsburgh Chamber of Commerce's SEC Comment Letter.

[32] The SEC made a similar observation on page 67 of the Proposal.

[33] The SEC made a similar observation on page 499 of the Proposal.

[34] Two percent is referred to as the "default option." The Proposal noted that a fund's directors may also determine that a lower fee would be in the best interest of the fund. Page 174 of the Proposal.

Stand-by liquidity fees and temporary redemption gates do not meaningfully address the risks to financial stability posed by MMMFs.[35] This option does not eliminate run risk as investors could have an incentive to redeem *before* their fund breaches the WLA threshold (similar to the incentive to run under the *status quo* as described in Section I).[36] Because investors are unable to predict how other investors would react once a fund's WLA level begins to deteriorate, their safest option may be to run in advance of the fund breaching the trigger. Further, because of the relative homogeneity in many MMMFs' holdings,[37] the imposition of a liquidity fee or redemption gate on one fund may incite runs on other funds which are not subject to such measures.

Another relevant consideration is the degree of investor concentration in some MMMFs. For example, of the five largest prime institutional MMMFs as of month-end June 2013, three had at least two shareholders each with a 5 percent or greater stake in the fund (across all share classes).[38] Such investor concentration may result in an otherwise sound fund approaching or breaching the 15 percent WLA threshold if one or two large investors redeem for idiosyncratic reasons unrelated to the fund itself. Other investors in that fund may run if they are concerned about the potential imposition of fees or gates. Investors in other MMMFs may in turn run if they perceive that their funds are similar (e.g., similar portfolio composition, similar maturity profile, similar investor concentration) to the fund that experienced the initial run. The result could be a broader MMMF run that takes place absent initial distress at any particular fund.[39] As this represents a new run mechanism that does not exist under the *status quo*, the fees-and-gates alternative may actually increase run risk relative to not enacting further reform.

Lastly, we are concerned with the potential loss of liquidity (for up to 30 days) associated with the imposition of temporary redemption gates, as both households and businesses use MMMFs extensively as transaction accounts.[40]

## Section IV Observations on Other Reforms Proposed

In addition to the two principal alternatives, the SEC proposes other enhancements, such as new and more frequent disclosures, and tightened diversification requirements. We support these additional reform elements and briefly discuss them below.

We strongly support the enhanced disclosure requirements contained in the Proposal. As proposed, MMMFs would be required to disclose current and historical instances of sponsor financial support; Daily Liquid Assets ("DLA") and WLA levels; current NAV rounded to the fourth decimal place; and daily net flows.[41] The SEC also proposes to require MMMFs to promptly file (within one business day) a new

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[35] Liquidity fees and temporary redemption gates notwithstanding, we recognize the importance of maintaining a fund board's ability to suspend redemptions in order to liquidate a fund – as specified in 2010's amendments to Rule 2a-7. Refer to Footnote 9 for more on 2010's amendments to Rule 2a-7

[36] The Proposal acknowledges this shortcoming but identifies other benefits of the liquidity fees and temporary redemption gates alternative (Page 166 of the Proposal). We believe, however, that this shortcoming is substantial and outweighs the perceived benefits identified.

[37] As of month-end June 2013, the twenty largest corporate issuers accounted for approximately 44 percent of prime MMMFs' assets under management. Based on data from SEC Form N-MFP. As there are few large corporate issuers in which MMMFs invest, it is unavoidable that there will be significant overlap across different funds' portfolios.

[38] Of these three funds, the three largest investors accounted for no less than 15 percent of combined assets across all share classes. We excluded affiliated investors from this analysis because (to the extent that such investors have full discretion over such investments) they may opt not to redeem fearing such action may destabilize the fund. Based on data from fund companies' Statement of Additional Information ("SAI").

[39] As the Proposal notes, fund managers could reduce this risk by holding additional liquidity commensurate with their degree of investor concentration. However, this may not be a practical option for all funds.

[40] It is likely that such restricted access to MMMF investments would come at a time when liquidity needs are greatest.

[41] Some fund complexes have voluntarily begun reporting daily market based NAV (Footnote 16) and daily DLA and WLA levels (*See, e.g.*, JP Morgan's daily DLA and WLA disclosure announcement), and some report portfolio holdings more frequently than monthly.

Form N-CR when certain significant events occur, and to eliminate Form N-MFP's 60-day public dissemination delay.[42]

We encourage the SEC to implement additional steps to enhance disclosure such as requiring weekly or even daily disclosures of portfolio holdings. During times of stress, uncertainty regarding portfolio composition could cause a MMMF's investors to redeem if they believe the fund could be exposed to distressed assets. More frequent disclosure alleviates this uncertainty.

In addition, we suggest that the SEC consider requiring MMMFs to publicly disclose their ten largest investors on a weekly or monthly basis.[43] Such disclosure would allow investors to better assess the shareholder concentration risk in the fund. A fund with a small number of large investors is more likely to experience large redemptions, and is thus more exposed to liquidity risk compared to a less concentrated fund.

Finally, we support the SEC's proposal to reduce issuer concentration risk by requiring MMMFs to consider the aggregate exposure of affiliated issuers for the purposes of the 5 percent issuer diversification requirement. As noted in the Proposal, a MMMF could be in compliance with the current requirement even if its aggregate exposure to affiliated entities exceeds the 5 percent limit. We suggest that the SEC consider if even tighter diversification limits and/or sector diversification requirements are necessary to reduce issuer concentration risk.

**Conclusion**

On November 19, 2012, the FSOC presented three reform alternatives as part of its Proposed Recommendations Regarding Money Market Mutual Fund Reform. In a comment letter submitted to the FSOC on behalf of the Presidents of the 12 Federal Reserve Banks on February 12, 2013, we noted that all three alternatives had "the potential to increase the resiliency of MMFs and reduce their susceptibility to runs." Of these three presented alternatives, the SEC has chosen to present the floating NAV alternative in their current proposal. Accordingly, we continue to fully support this alternative and urge the SEC to pursue this option and consider ways in which the benefits of a floating NAV could be enhanced, such as continuing to monitor funds' procedures for determining that amortized cost accurately reflects fair value and eliminating the "retail" exemption.

We continue to believe that the liquidity fees and temporary redemption gates alternative does not constitute meaningful reform and that this alternative bears many similarities to the status quo. Investors will still have an incentive to be the first to redeem and the price of those early redemptions (before the trigger is breached) may still be inaccurate and unfair to remaining shareholders if such redemptions occur under a fixed NAV regime.

We understand that among the many comment letters the SEC will receive on this Proposal, our position supporting the floating NAV alternative may well be in the minority, as it has been throughout this important debate. Indeed, to the extent that the fees and gates alternative resembles the status quo, it would be an attractive option if the only goal were to minimize the costs of adjustment within the MMMF

[42] Significant events would include: a portfolio security default or insolvency, sponsor support, and WLA levels falling below 15 percent (under the liquidity fees and temporary redemption gates alternative).
[43] We note that the identity of individual shareholders need not be disclosed, but rather the size of their investment in the fund. Under current requirements, all mutual funds disclose shareholders that own 5 percent or more of the outstanding shares of a class of funds. This information is reported annually in mutual funds' SAI with significant lag.

industry. From a financial stability perspective, however, we believe that the floating NAV is the far better choice.

We are grateful for the opportunity to comment on this Proposal and, again, applaud the SEC Commissioners and staff for moving forward with this initiative. We welcome the opportunity to elaborate on or further discuss any aspect of this letter.

President Eric S. Rosengren
Federal Reserve Bank of Boston

President William C. Dudley
Federal Reserve Bank of New York

President Charles I. Plosser
Federal Reserve Bank of Philadelphia

President Sandra Pianalto
Federal Reserve Bank of Cleveland

President Jeffrey M. Lacker
Federal Reserve Bank of Richmond

President Dennis P. Lockhart
Federal Reserve Bank of Atlanta

President Charles L. Evans
Federal Reserve Bank of Chicago

President James B. Bullard
Federal Reserve Bank of St. Louis

President Narayana R. Kocherlakota
Federal Reserve Bank of Minneapolis

President Esther L. George
Federal Reserve Bank of Kansas City

President Richard W. Fisher
Federal Reserve Bank of Dallas

President John C. Williams
Federal Reserve Bank of San Francisco

MFDF

MUTUAL FUND DIRECTORS FORUM
*The* FORUM *for* FUND INDEPENDENT DIRECTORS

September 17, 2013

The Honorable Scott Garrett
Chairman
House Subcommittee on Capital Markets and
Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett:

We appreciate your holding a hearing on September 18 entitled "Examining the SEC's Money Market Fund Rule Proposal." As the Subcommittee considers the SEC's proposal, the Mutual Fund Directors Forum would like to provide you with comments we submitted to the SEC, and ask that our letter be included with the hearing record.

The letter can be found at
http://www.mfdf.org/images/uploads/newsroom/MMF_Reform_20130916.pdf.

Thank you for your assistance.

Sincerely,

Susan F. Wyderko

Susan Ferris Wyderko
President, CEO

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FINANCIAL SERVICES ROUNDTABLE

**STATEMENT FOR THE RECORD**

**THE FINANCIAL SERVICES ROUNDTABLE**

for

The House Financial Services Committee,
Subcommittee on Capital Markets and Government Sponsored Enterprises

Hearing:

"*Examining the SEC's Money Market Fund Rule Proposal*"

September 18, 2013

The Financial Services Roundtable represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. FSR member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

**FSR urges the Securities and Exchange Commission to preserve viability of MMMFs for cash management, and financing of state and local governments, pension plans, and companies.**

On 19 June 2013, the Securities and Exchange Commission (the "Commission") proposed that any prime institutional money market mutual fund ("MMMF") either float the net asset value ("NAV") of its shares ("Alternative 1"); or impose a stand-by liquidity fee of 2% if the fund's weekly liquid assets fall below 15% and impose a redemption gate if the fund's liquidity levels fall below the 15% weekly liquid asset threshold ("Alternative 2"), subject to the fund's board determination that imposing fees or gates would be in the best interest of the fund (collectively, the "Proposal"). The Commission also suggested that it may adopt either alternative or some combination of the two alternatives without further specification of the terms of the proposed combination. The Commission proposed further diversification, disclosure, and reporting requirements for MMMFs. *See Money Market Fund Reform; Amendments to Form PF*, Securities Act Release No. 9,408 [File No. S7-03-13], 78 FEDERAL REGISTER 36,834 (June 19, 2013), *available* here. A summary of FSR's comments is below.

**Reform must not harm the fundamental attractiveness of MMMFs to investors or to government or corporate borrowers who rely on MMMFs for competitive, short-term financing.** In its comments on the proposed reforms, FSR urged the Commission to preserve the viability of MMMFs as (1) flexible and convenient ways for individuals and corporate treasurers to manage their daily cash needs; and (2) cost-effective ways to finance short-term obligations at competitive market rates for governments at all levels (federal, state and local), companies, pension plans, hospitals, and other not-for-profit entities. A regulation that would combine Alternatives 1 and 2 may result in an excessive and possibly insurmountable deterrent to investors and the industry. *See* FSR's Comment Letter, *available* here (the "FSR Letter").

**Reform must address the accounting, tax, and operational issues raised by the proposed regulatory régime.** FSR also met with the Commission's Chief Accountant and other senior Staff, and the Technical Director for the Financial Accounting Standards Board ("FASB") to review accounting and financial reporting issues raised by the Commission's proposals. The FSR Letter urged the Commission, FASB, and the Governmental Accounting Standards Board to codify the treatment of MMMFs as "cash equivalents" if the Commission were to adopt either of its proposed reform alternatives.

Although the Department of the Treasury (the "Treasury") and the Internal Revenue Service have proposed an exemption from the "wash sale" rules for *de minimis* redemptions from floating NAV MMMFs, the proposal fails to minimize the substantial operational burdens associated with a floating NAV. *See Application of Wash Sale Rules to Money Market Fund Shares* [Notice 2013-48], *available* here. Accordingly, FSR recommended that the Commission coordinate with Treasury an exemption from the "wash-sale" rules for floating NAV funds to eliminate burdensome tracking of *de minimis* purchase and redemption transactions.

Based on a recent study, FSR noted that also Commission failed to consider fully the operational costs to implement Alternative 1, which estimates range from (a) $1.8 to $2 billion in up-front costs for institutional investors to modify their business process operations and systems; and (b) $2 to $2.5 billion dollars in annual operating costs. *See* CENTER FOR CAPITAL MARKETS COMPETITIVENESS, *Operational Implications of a Floating NAV across Money Market Fund Industry Key Stakeholders* (Summer 2013), *available* here.

**The Commission should exempt "municipal funds" and "retail funds" from both proposed reform alternatives.** FSR noted that an exemption for municipal securities or tax-exempt MMMFs ("Municipal Funds") would be appropriate because Municipal Funds are neither vulnerable to the perceived run risks associated with institutional prime MMMFs, nor are they a source of potential financial contagion.

FSR also supported an exemption for retail funds, which would ensure that individual investors do not bear the burden of mitigating the run-risk perceived to be presented by institutional investors. FSR does not support defining the retail funds exemption based on a redemption restriction of $1 million per day; however, it urged the Commission to establish an inflation-adjusted "daily redemption-limit" of at least $2 million to $5 million, because it believes an increase would enable many individual investors to continue using MMMFs to manage their cash needs. Finally, FSR urged the Commission to exempt individual investors from the $1 million daily redemption limit if they give advance notice of their redemptions. FSR believes an "advance-notice" exemption would maintain investors' access to their cash for predictable outflows, such as buying a home.

Other points made in the FSR Letter include:

- **ERISA Plans should be exempted from Redemption Gates.** Redemption gates may render MMMFs unsuitable for ERISA plans if fiduciaries cannot redeem shares while a gate is "down."

- **Liquidity Fees should represent the fund's cost of redemptions.** If and when a fund's board of directors—in the exercise of its business judgment—determines that a liquidity fee or a redemption gate is in the best interests of a fund, the amount of the liquidity fee should be representative of the actual cost of redemptions to the fund.

- **The Commission must solicit public comments on the particulars of a "combined Alternative 1 and Alternative 2."** Although several FSR members are not necessarily opposed to a potential combination of Alternatives 1 and 2, the Commission failed to propose for comment the particulars of a potential combination. A regulation that would combine Alternatives 1 and 2 may result in an excessive and possibly insurmountable deterrent to investors and the industry. In the absence of meaningful guidance on the terms of any proposed combination of Alternatives 1 and 2, FSR stated it was unable to provide substantive comments without greater clarity on the composition of a rule that would combine some elements of both alternatives.

OFFICE OF THE GOVERNOR
COMMONWEALTH OF MASSACHUSETTS
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DEVAL L. PATRICK
GOVERNOR

September 17, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

RE: *Comment Letter to the Securities and Exchange Commission on Money Market Fund Reform; File No. S7-03-13*

Dear Ms. Murphy:

On June 5, the Securities and Exchange Commission ("SEC") released a proposed rule that would amend the regulatory structure for money market mutual funds (MMFs). I commend the SEC for their diligence in addressing this important issue to investors.

As Governor of Massachusetts, I have worked to create a business environment that facilitates economic growth and job creation. To that end, I am fully supportive of regulation that encourages capital creation and allows businesses and governments to finance projects in a fair and equitable manner. I am, however, concerned that the SEC's currently proposed MMF rule may have a negative impact on the Commonwealth of Massachusetts and the cities and towns I represent as Governor.

Massachusetts and its municipalities regularly issue short-term debt securities that are primarily purchased by money market mutual funds. In fact, in 2012 the Commonwealth and its municipalities sold over $3.5 billion in short-term notes at very attractive financing rates. This short-term debt is used to provide capital for projects throughout

the entire state, including school construction, transit projects, water and sewage treatment facilities and other vital public services.

I am concerned over the current SEC proposal's inclusion of new regulations for municipal MMFs, including removing the stable $1.00 net asset value and allowing for fees and redemption gates. As you are well aware, many investors have indicated they would no longer use MMFs if these types of changes are made to the basic structure of the MMF product. I believe that less investment in MMFs will lead to less availability of capital and a limitation on the ability of MMFs to purchase debt from municipalities, subsequently leading to increased borrowing costs for state and local governments. As funding from MMFs contracts, financing costs for municipalities in Massachusetts would rise and important public projects would either be more expensive or potentially delayed.

Further, the SEC rightly recognizes the negative impact new regulations would have on MMFs that invest in U.S. Treasury and government securities by excluding these MMFs from the floating NAV or the redemption gates and fees alternatives. I believe that municipal issuers of debt should not be treated differently than federal entities, and am concerned that including municipal MMFs in the SEC's proposed regulations would put local governments at a financing disadvantage to the federal government in the capital markets.

As the SEC moves forward with consideration of this proposal, I urge you to take into consideration the important role MMFs play in meeting the financing needs of states and municipalities, and request that municipal MMFs be excluded from new regulations under the SEC proposal.

Sincerely,

MASSACHUSETTS
MUNICIPAL
ASSOCIATION

ONE WINTHROP SQUARE, BOSTON, MA 02110
617-426-7272 • 800-882-1498 • fax 617-695-1314 • www.mma.org

September 9, 2013

The Honorable Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File Number S7-03-13- Money Market Fund Reform

Dear Secretary Murphy:

On behalf of the 351 cities and towns of the Commonwealth of Massachusetts, the Massachusetts Municipal Association appreciates the opportunity to offer comment on the proposed rule changes regarding the regulation of money market mutual funds (MMMFs). We respectfully oppose the proposed rule changes, and we are very concerned that the proposals would harm local governments by taking away an important cash management tool, increasing market instability, and making municipal bonds less attractive to investors. We urge the SEC to retain a fixed NAV as an important component of both established municipal financial practices and continued economic growth.

We understand that the Securities and Exchange Commission (SEC) has proposed switching from a fixed net asset value (NAV) for MMMFs to a floating NAV, and has proposed implementing investor redemption restrictions. These proposed regulatory changes would require MMMFs to sell and redeem shares based on the present market-based value of the securities in their underlying portfolios, and would also make it more difficult for investors to redeem MMMFs.

Money market mutual funds with a fixed NAV are a common cash management tool for local governments. Because the funds have a fixed NAV, they are considered both stable and low-risk – a necessity for local government investment. A floating NAV would decrease stability and increase risk, making MMMFs a far less attractive, or even impossible, cash management option for local governments. Additionally, a fixed NAV allows local governments to utilize automated accounting software. Many local governments simply to do not have the internal capacity to manage the financial complexities of a highly variable floating NAV system, and could experience problems with purchases and redemptions. Ironically, the adoption of a floating NAV could make less regulated or more risky cash management vehicles more attractive to municipalities from an administrative perspective.

Money market mutual funds are characterized by principal stability, liquidity, and payment of short-term yields. A fixed NAV is a primary component of this stability, and a change to a floating NAV would only decrease stability and create uncertainty – making MMMFs far less

attractive to investors. The ensuing instability would cast a shadow on MMMFs and jeopardize financial recovery at the municipal level.

Robust municipal MMMF demand for short-term bonds increases demand in the long-term municipal bond market, resulting in lower financing costs for crucial local government capital projects. Municipal bonds are widely used to finance critical infrastructure projects in communities nationwide. Approximately 90 percent of municipal bond financing over the past decade went toward schools, hospitals, water infrastructure, sewer facilities, public power utilities, roads and mass transit. Last year, municipal bonds financed $179 billion in state and local infrastructure projects nationwide. If the municipal bond market becomes less attractive to investors due to changes in the MMMF market, state and local borrowing costs would increase significantly. This would have a major chilling effect on local capacity for growth and development. Because MMMF demand and municipal bond demand are linked, it is essential to retain the attractiveness and stability of fixed NAV MMMFs.

The SEC has not proposed subjecting Treasury and government money market funds to further regulation, recognizing that these funds have largely different characteristics from prime MMFs. Municipal MMFs behave similarly to Treasury and government funds during times of market stress, maintaining high levels of asset liquidity. They did not experience the same runs during the financial crisis of 2008 that prime MMFs experienced. Given the highly negative consequences that would result, there is no compelling reason to regulate municipal MMFs as if they were prime MMFs, rather than regulating them similarly to the Treasury and government MMFs with which they share numerous characteristics.

Thank you for the opportunity to bring these concerns to your attention. We appreciate the work that you do to promote financial stability and market recovery. We urge the Commission to carefully consider the negative impacts that the adoption of a floating NAV would create for local government. Please reject the proposed rule changes and retain the current regulations. If you have any questions, please do not hesitate to have your staff contact Catherine Rollins or John Robertson of the MMA at 617-426-7272 or by email at [redacted] and [redacted].

Thank you very much.

Sincerely,

Geoffrey C. Beckwith
Executive Director

February 21, 2014

Hon. Keith Ellison
U.S. House of Representatives
2244 Rayburn HOB
Washington, D.C. 20515

Dear Congressman Ellison,

The purpose of this letter is to respond on behalf of Charles Schwab & Co., Inc. to the additional questions you sent our witness, Marie Chandoha, following her testimony at the September 18, 2013 hearing on money market fund reform held by the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises. Since Ms. Chandoha's responsibilities as President and CEO of Charles Schwab Investment Management (CSIM) do no involve Schwab's broker-dealer customer agreements, I am responding to your questions regarding mandatory arbitration and related issues.

***Question***

In 2011, Schwab became the first and only brokerage to insert clauses in your customer service contracts banning your customers from participating in any class action lawsuit against your company. This is in ADDITION to the requirement in your agreements, which is also used by other brokerages, mandating that disputes with individual client be settled through arbitration. Your regulator FINRA, is challenging the legality of your class action waiver as a violation of its member rules. And I believe your firm issued a statement on your website on May 15 (which I note, I can no longer locate) announcing a temporary suspending of this practice, pending resolution of the FINRA action against you.

My question is why Schwab, alone among brokers, feels that its clients should have to give up their right to participate in class actions?

***Schwab Response***

Schwab does not believe it appropriate to comment on what other broker-dealers may or may not feel about their customers' participation in class actions. It is evident, however, that Schwab is only one of many companies in many industries which acted to amend

Hon. Keith Ellison

Page 2

their arbitration agreements to include a class action waiver following the landmark decision of the United States Supreme Court in *AT&T Mobility v. Concepcion.* Schwab is aware of credit card companies, banks, phone companies, auto makers, and retailers adopting such provisions.

Schwab has come to the conclusion that class action litigation is not an efficient, effective, or fair procedural method for resolving customer disputes. Schwab's experience and a number of well-supported academic studies show that class actions are slow to be resolved, that a substantial percentage of filed actions never survive motions to dismiss, almost no such cases go to trial, and those that result in a settlement return very little to the class members, especially when compared to the size of the attorneys' fees awarded to class counsel. Because of the size of putative classes and the large potential exposure to defendants inherent in class actions, many defendants settle cases in which they have meritorious defenses to avoid the risk of a large adverse verdict. In contrast, Schwab's experience with arbitration, especially with FINRA's forum, is that cases move quickly, efficiently, and fairly, and that customers have low-cost methods to resolve small disputes.

***Question***

Why don't you put an end to this abusive practice - not temporarily - but permanently?

***Schwab Response***

For the reasons stated above, Schwab does not regard class action waivers as abusive and indeed believes that individual arbitration is a far more fair, efficient and cost-effective forum for all parties involved.

***Question***

If you are successful in stopping FINRA's legal challenge, are you planning to reinsert the class action waiver in your account agreements, or are you going to reevaluate whether taking away the right to go to court is fair to your customers?

***Schwab Response***

Schwab will evaluate its position after it has the opportunity to review the ruling on FINRA's appeal.

Hon. Keith Ellison

Page 3

***Question***

I am very concerned about small investors having access to the courts. Putting aside the question of whether or not it is legal: do you believe it is fair for small investors to be forced to waive all their rights to go to court to settle disputes, before the dispute even occurs or can be understood? Against a company of your size?

***Schwab Response***

Schwab believes that it is entirely fair for it and its customers to agree to resolve any disputes through individual arbitration, which has proven to be fair, efficient and cost-effective. Mandatory pre-dispute arbitration blossomed throughout the securities industry after the United States Supreme Court decided the *Shearson v. McMahon* case in 1987. That case held that the federal securities laws did not prohibit mandatory pre-dispute arbitration. Since that time, tens of thousands of arbitrations have been held before arbitration panels operating under rules adopted by NASD, New York Stock Exchange, FINRA, American Stock Exchange, Pacific Stock Exchange and others. The arbitration rules of each forum are reviewed and approved by the SEC. There are no properly supported studies which have found any material patterns of bias or unfairness in these arbitrations. Schwab believes that arbitration is fair to both sides no matter the size of the claim or the size of the respondent broker-dealer.

Thank you for this opportunity to respond to your questions.

Sincerely,

Jeff Brown
Senior Vice President, Legislative and Regulatory Affairs
Charles Schwab & Co., Inc.

November 26, 2013

charles SCHWAB

Hon. Randy Hultgren
U.S. House of Representatives
332 Cannon HOB
Washington, D.C. 20515

Re: Committee On Financial Services

Dear Congressman Hultgren,

The purpose of this letter is to respond on behalf of Charles Schwab & Co., Inc. to the additional questions you sent our witness, Marie Chandoha, following her testimony at the September 18, 2013 Hearing on Money Market Funds Reform by the above-named committee. Since Ms. Chandoha's responsibilities as President and CEO of Charles Schwab Investment Management (CSIM) do no involve Schwab's broker-dealer customer agreements, I am responding to your questions regarding mandatory arbitration and related issues.

***Question***

"Mandatory" arbitration between customers and their broker-dealer is hard wired into FINRA rules, which require broker-dealers to arbitrate disputes if the customer elects. Broker-dealers gain the same right by including arbitration clauses in customer contracts. If the goal is to ban mandatory arbitration, would you agree that customers and broker-dealers are entitled to fair and equal treatment, whether the mandatory arbitration is imposed through FINRA rules, or through an arbitration clause in a customer contract?

***Schwab Response***

Schwab agrees that it would be unfair to subject broker-dealers to mandatory arbitration at the election of a customer under FINRA rules, but at the same time to prohibit broker-dealers from including provisions in agreements that mandate arbitration of all customer disputes. Pre-dispute forum selection is a matter of contract and commercial reasonableness, in which the parties define their rights and obligations at the outset of their relationship. In contrast, plaintiffs' lawyers and other proponents of ending mandatory arbitration seek to provide customers with unilateral, post-dispute choice of forum. However, to subject one of the parties to a dispute to the preferred forum of the other party based on a perceived tactical advantage would greatly undermine the fairness of the proceedings. The elimination of pre-dispute arbitration agreements from broker-

Hon. Randy Hultgren
November 26, 2013
Page 2

customer contracts also could lead to litigation over whether FINRA rules purportedly requiring brokers to arbitrate at the election of a customer are enforceable under the Federal Arbitration Act in the absence of a contract between the customer and broker.

A system of unilateral choice also raises risks for customers and the viability of FINRA Dispute Resolution as a forum. Plaintiffs' lawyers, for whom civil litigation is more lucrative, would be incented to push their clients to file disputes in court, to the detriment of cost and efficiency and the interests of customers whose claims would be better served in arbitration. Moreover, the tendency for plaintiffs' lawyers to litigate claims (especially larger ones) in court will inevitably present resource challenges and downsizing for FINRA's forum, to the likely detriment of the program generally and certainly at the expense of customers with smaller claims.

***Question***

Please describe the benefits to customers in the current securities arbitration system. Would it be sound policy to replace a system that works well in favor of an entirely new approach where no effort has been made to study and understand the prospective risks?

***Schwab Response***

FINRA Dispute Resolution offers customers and brokers a cost-effective, prompt, and fair forum for resolving disputes on an individual basis. Over the years, this forum has been very responsive to consumer and industry feedback. It has modified existing procedures and added new ones to allow it to address legitimate concerns voiced by both investors and the industry. Customers can initiate cases with a small up-front fee based on the size of the claim. Neutral arbitrators are selected by both sides from lists providing background and prior case histories. Arbitrators employed by or with previous ties to the securities industry are classified as industry arbitrators, and customers are free to strike them from the list and have a panel of three public arbitrators. The arbitrators are typically well-trained and familiar with the rules and regulations of the industry and with the types of products generally at issue in arbitration cases. Discovery is focused and limited so as to be a tool for resolution of cases rather than a weapon to extract a settlement. Arbitrators are encouraged to set cases for hearing in a prompt and fair manner so that a customer using this forum can expect a resolution of his or her case far more promptly than in most court settings. FINRA Dispute Resolution has a set of streamlined procedures for small disputes that cut the cost, paperwork and time needed to reach resolution. In contrast to Court proceedings, arbitration offers a much higher

degree of finality because hearing dates are not typically postponed multiple times and awards are not appealable except in extreme and unusual circumstances. Moreover, FINRA Rules require prompt payment of monetary awards without the necessity of judgment collection procedures. The system is the product of decades of experience and innovation and should not be discarded without demonstrable evidence that an alternative would produce better results.

***Question***

Would H.R. 2998, the "Investor Choice Act of 2013," introduced on August 2, 2013, effectively eliminate arbitration as a dispute resolution option for investment advisor clients? Would the customer of an investment adviser have any mechanism to compel arbitration if the investment adviser did not agree to resolve a dispute using arbitration? How would this system protect aggrieved customers of an investment adviser?

***Schwab Response***

Because investment advisors are not subject to mandatory, rule-based arbitration, the elimination of arbitration provisions in agreements between customers and investment advisors will limit customers either to proceedings in court or to a forum that both parties might agree upon after a dispute has arisen.

***Question***

Would H.R. 2998 create a further bifurcated standard for dispute resolution as between broker-dealers and investment advisers? Does it make sense to have a bifurcated system?

***Schwab Response***

As this question recognizes, there already exists a "bifurcated" system for dispute resolution because broker-dealers are subject to mandatory, rule-based arbitration and investment advisors are not. This current system creates a problem in the case where an investor has a custodial relationship with a broker-dealer, but where disputed investments in the custodial account are directed by an independent investment advisor. Unless both the custodian and advisor have arbitration agreements designating the same forum, the investor must pursue the custodian in one forum (likely FINRA) and the advisor in another (perhaps AAA or in court). This result creates inefficiencies, and incentivizes customers to bring claims against custodians in arbitration when the investments at issue

were made by -- and the alleged losses caused by -- the advisor. This problem has been compounded by guidance from FINRA stating that it will administer the arbitration of disputes involving investment advisors but will require a *post-dispute* arbitration agreement to do so. We believe FINRA should enforce *pre-dispute* arbitration agreements between customers and their investment advisors that designate FINRA as the arbitration forum, particularly where a FINRA member broker-dealer is a party to the proceeding. H.R. 2998 could make this problem worse by eliminating pre-dispute arbitration agreements between customers and advisors, and thereby ensuring separate proceedings against custodians and advisors.

Thank you for this opportunity to respond to your questions.

Sincerely,

Jeff Brown

Jeff Brown
Senior Vice President, Legislative and Regulatory Affairs
Charles Schwab & Co., Inc.

**Investment Company Institute**
**November 27, 2013**

**Follow-up Questions for Mr. Paul Stevens on House Financial Services Committee Hearing:**
**Examining the SEC's Money Market Fund Rule Proposal – September 18, 2013**

**Questions from Congressman Garrett**

**Question 1**

It was suggested at the hearing that the SEC's proposal to allow retail money market funds to continue to maintain a stable NAV will put retail investors at risk because certain investors "will continue to have an incentive to run at the first sign of trouble." Is this correct?

**ICI Answer**

It is important to recognize that the SEC's proposal to allow retail money market funds to maintain a stable NAV would separate institutional investors, who can have highly variable cash balance needs, from retail investors, whose cash balances tend to be more stable. Retail investors did not redeem heavily from retail money market funds following Lehman Brothers failure in September 2008. This indicates that by segmenting institutional and retail investors there is little reason to be concerned that retail investors will be put at risk.

**Question 2**

Ms. Sheila Bair has argued that the SEC's proposal to allow government money market funds to maintain a stable NAV would provide a subsidy to the U.S. Treasury as well as GSEs, which will create perverse incentives in the market through maturity mismatch and interest rate risk. Do you agree with this point of view? Should the SEC require government money market funds to have a floating NAV? Why or why not?

**ICI Answer**

No, we do not agree that allowing government money market funds to maintain a stable NAV would encourage the Treasury and GSEs to take on too much interest rate risk. The U.S. Treasury is able to make its financing decisions that are optimal for the U.S. taxpayers. The GSEs and their regulator can manage the interest rate risk of the GSEs regardless of the interest rates offered on short-term instruments.

The suggestion that the ability of money market funds to buy and hold Treasury and agency securities somehow contributes to maturity mismatch and interest rate risk is

misplaced. Given its funding needs, the Treasury generally issues debt securities along the full range of the yield curve, with considerations given to when spending is likely to occur, when tax revenues are expected to be received, and the slope of the yield curve. If anything, contrary to Ms. Bair's contention, the Treasury recently has issued relatively more intermediate- to long-term debt and less short-term debt (*i.e.*, T-bills) in order to lock in low-cost long-term funding.

The SEC has proposed to exempt government money market funds from further structural reform because, among other things, government money market funds are not as susceptible to the risks of mass investor redemptions as other money market funds may be; their securities have low default risk and are highly liquid in some of the most stressful market scenarios; and interest rate risk is generally mitigated because government funds typically hold assets that have short maturities and hold those assets to maturity. Importantly, during periods of financial stress, government money market funds typically experience inflows, rather than outflows. These funds' asset values also tend to appreciate, rather than depreciate, in times of stress. Indeed, the SEC staff found that government funds received "abnormally large daily net inflow during the calendar week [September 15-19, 2008] of the crisis."[1] We agree with the SEC that no case can be made for applying fundamental changes to government money market funds.

**Question 3**

Several panelists indicated that tax-exempt money market funds provide significant short-term funding to states and municipalities for which borrowing costs could rise if the SEC does not provide a carve-out for tax-exempt money market funds from its rule proposal. Please provide figures on the total dollar funding that tax-exempt money market funds supply to states and municipalities. Is the funding that tax-exempt money market funds supply more important to specific states, regions, or types of municipalities? Also, please provide information on the twelve largest recipients of funding from tax-exempt money market funds.

**ICI Answer**

Funding provided by tax-exempt money market funds does vary by state; states with larger populations generally receive greater total dollar financing. For example, the state of New York and municipalities in New York received $38.5 billion in financing from tax-exempt money market funds as of July 31, 2013, which amounted to about $2,000 in financing per person in the state of New York. Massachusetts received less financing in dollars, $10.5 billion, but because of its smaller population that amounted to almost the same amount per person ($1,600) in that state.

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[1] *See* SEC Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (November 30, 2012) ("SEC Staff Study"), available at http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf, at 12.

**Top 12 States by Tax-Exempt Money Market Fund Investments**

*Municipal Securities, top 12 states, dollar billions, July 31, 2013*

| Rank | State | Investment |
|---|---|---|
| 1 | CA | $40.7 |
| 2 | NY | 38.5 |
| 3 | TX | 20.9 |
| 4 | IL | 12.8 |
| 5 | MA | 10.5 |
| 6 | FL | 9.2 |
| 7 | PA | 8.7 |
| 8 | NJ | 7.3 |
| 9 | OH | 6.9 |
| 10 | NC | 5.3 |
| 11 | GA | 5.2 |
| 12 | MI | 4.7 |

*Source: ICI tabulations of SEC Form N-MFP data*

Funding that state and local governments receive from tax-exempt money market funds is used for a variety of purposes, such as providing financing for general obligation bonds, providing interim financing through tax or revenue anticipation notes, or helping finance housing, water systems, or other infrastructure (*see* table below).

**Top 12 Issuers Held by Tax-Exempt Money Market Fund Investments**

*Municipal Securities, top 12 issuers, dollar billions, July 31, 2013*

| Rank | Issuer | Investment |
|---|---|---|
| 1 | State of Texas | $5.3 |
| 2 | New York Housing Finance Agency | 5.3 |
| 3 | State of New York | 4.7 |
| 4 | California Community Development Authority | 4.7 |
| 5 | Illinois Development Finance Authority | 3.7 |
| 6 | New York Municipal Water Finance Authority | 3.2 |
| 7 | New York Dormitory Authority (DASNY) | 3.0 |
| 8 | State of California | 2.7 |
| 9 | New York Housing Development Corporation | 2.6 |
| 10 | California Health Facilities Finance Authority | 2.5 |
| 11 | New York Transitional Finance Authority | 2.4 |
| 12 | Massachusetts Health & Educational Facilities Authority | 2.3 |

*Source: ICI tabulations of SEC Form N-MFP data*

## Question 4

Amortized cost valuation has been referred to as a fiction that encourages investors to "game" money market funds and promotes runs. But during the hearing, Mr. Stevens

indicated that amortized cost accounting is a standard practice used by essentially all firms. Can you please provide details on the kinds of firms other than money market funds that use amortized cost accounting, under what circumstances, and under what authority (*e.g.*, is this determined by a company's internal policies or FASB)?

**ICI Answer**

Amortized cost is the purchase price of a security adjusted for accretion of discount or amortization of premium. Accretion of discount involves increasing the value of the security ratably over its life so that at maturity its amortized cost value is equal to the maturity value. *All* companies other than investment companies use amortized cost to value securities that are "cash equivalents," including banks and insurance companies. Even the Federal Reserve System uses amortized cost to value *all* of it holdings of Treasury and agency securities, and the Federal Deposit Insurance Corporation uses amortized cost to value securities held by the National Liquidation Fund.

Generally accepted accounting principles (GAAP) define cash equivalents as short-term, highly liquid securities that are both (i) readily convertible to known amounts of cash, and (ii) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.[2] Generally only investments with original maturities of three months or less satisfy this definition. Securities commonly considered cash equivalents include Treasury bills, commercial paper, and money market funds. Because their maturity is limited to three months or less, the amortized cost value of cash equivalents is the same as, or not materially different than, their market value.

Treasury bills, for example, are a type of security that is typically valued at amortized cost. Treasury bills are referred to as "discount instruments" because they are issued at a price that is less than their maturity value. The increase in value from original issuance to maturity represents interest income to the holder of the Treasury bill. Under amortized cost a Treasury bill is initially valued at its cost (*i.e.*, the acquisition price). Cost is increased ratably over the life of the bill such that at maturity its amortized cost is equal to the maturity value.

GAAP requires all companies (other than investment companies) to use the amortized cost method of valuation for long-term debt securities in certain circumstances. Companies that invest in debt securities must classify those securities into one of three categories: trading, available for sale, or held-to-maturity. Debt securities classified as held-to-maturity are valued at amortized cost.[3] The justification for using amortized cost valuation for debt securities classified as held-to-maturity is that

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[2] FASB Accounting Standards Codification 305-10-20.

[3] FASB Accounting Standards Codification 320-10-35-1. Debt securities classified as held-to-maturity are subject to impairment testing (*e.g.*, for credit losses). If the impairment is other than temporary, the amortized cost value of the security is adjusted to reflect the impairment.

no matter how market interest rates fluctuate, the holder will recover its recorded investment and thus realize no gain or loss when the issuer pays the amount promised at maturity. Companies holding debt securities classified as held-to-maturity typically have a "hold to collect" business model, as opposed to short-term trading to realize changes in value.

Investment companies other than money market funds also may use amortized cost to value short-term debt securities. SEC Accounting Series Release 219 permits mutual funds (*e.g.*, equity funds, bond funds) to value securities maturing in 60 days or less at amortized cost.[4] Thus, fluctuating NAV funds, which often invest a small portion of their assets in short-term fixed income securities, routinely use amortized cost to value debt securities with a remaining maturity of 60 days or less.

**Question 5**

Ms. Sheila Bair suggested in September 2008 after Lehman Brothers failed, causing the Reserve Fund to break a dollar, other money market funds caused the wholesale funding markets to seize up. Is this consistent with your understanding of financial market events during that period? What evidence is there one way or the other on this issue?

**ICI Answer**

The notion that money market funds caused short-term credit markets to freeze conveniently ignores altogether the context of those events—what Federal Reserve Chairman Ben Bernanke has described as "the worst financial crisis in global history, including the Great Depression." This crisis had reached a critical stage long before September 2008: at least 13 major institutions had gone bankrupt, been taken over, or been rescued during the 12 months before Lehman Brothers was allowed to fail, triggering Reserve Primary's problems.

The commercial paper markets began to seize up before prime money market funds experienced significant outflows and continued to suffer lack of liquidity long after those outflows abated. On September 15, when Lehman announced its bankruptcy, commercial paper markets were hit hard. Lehman had been one of the largest commercial paper dealers, and its bankruptcy eliminated a key source of liquidity in the market. Merrill Lynch also was a large commercial paper dealer, and its emergency sale to Bank of America negatively affected the market.

On the same day that Reserve Primary broke the dollar, American International Group (AIG) collapsed and was rescued—signaling that even investment-grade firms could fail almost without warning. Following these events, concerns rapidly spread in

[4] SEC Accounting Series Release 219, Release No. IC-9786 (May 31, 1977).

financial markets that the debt of numerous other large investment and commercial banks posed much greater risk than previously thought.

In this maelstrom, investors everywhere reacted to the widespread uncertainty over the stability of financial institutions and the lack of predictable government policy responses to a crisis gripping the global banking system. Money market fund investors were not the only investors reacting to these market events—they were simply among the most easily observable market participants.

On the day of Lehman's bankruptcy, investors began pulling back from longer-dated paper. From the middle of September through late October, commercial paper market issuance was heavily weighted to paper with four days or less to maturity. Financial issuers of commercial paper were particularly hard hit, and most issuers were unable to issue paper with maturities extending much beyond a month. For example, in the four weeks after Lehman collapsed, on average, only 14 issues of financial paper with maturities beyond 40 days reached the market each day, compared with a daily average of 140 in early September. The daily dollar volume of new financial paper issuance with these maturities was equally impaired, averaging $152 million, compared with $2.9 billion during the first half of September. Prime money market funds sold some commercial paper to meet redemption requests, but other investors also were large sellers in September, and these investors continued to reduce their commercial paper holdings. Outstanding commercial paper declined by $185 billion during September. Money market funds reduced their holdings by $164 billion and investors other than money market funds reduced their holdings by more than $170 billion. The Federal Reserve's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) offset about half of the overall investor pullback in the market.

The commercial paper market continued to contract through much of October, even though money market funds became net buyers during this time. It was not until the Federal Reserve's Commercial Paper Funding Facility, or CPFF, became operational in late October that outstanding commercial paper started to expand. For the month of October as a whole, total outstanding commercial paper grew by $29 billion with money market funds increasing their commercial paper holdings by $43 billion. As is evident, other investors continued to pull back from this market and more than offset money market funds' purchases in October.

Elsewhere in the short-term markets, it is clear that a variety of market participants were pulling back their exposures to financial institutions. For example, in September 2008 the repurchase agreement market shrank by $400 billion. In that case, money market funds did not contribute at all to the contraction: instead, money market funds increased their holdings of repos, by a little over $90 billion during that month.

Even during the week between September 16 and 23, money market funds expanded their lending in the repo market by $67 billion. During the last four months of

2008, the repo market shrank by $1.6 trillion. During this same time, money market funds increased their supply of credit to the repo market by $44 billion.

Clearly, some investors other than money market funds had to account for the pullback in the repo market and the subsequent difficulties of financial institutions in obtaining this type of short-term wholesale funding.

Banks also quit lending to each other. Interbank lending by commercial banks fell more than 30 percent, or nearly $145 billion, on a seasonally adjusted basis. The stresses were reflected in the spread between the three-month London Interbank Offered Rate (LIBOR) and the overnight index swap (OIS) rate, a traditional measure of the health of the banking sector. The LIBOR-OIS spread jumped from less than 100 basis points on September 12, 2008, to nearly 370 basis points one month later, as banks pulled back from lending to each other. (We now know that, if anything, the LIBOR-OIS spread may have understated the pressures in the banking system, based on reports that certain banks participating in the LIBOR survey were underreporting their funding costs.)

What hit the short-term credit markets in September 2008 was a flight to safety—that is, a near-universal retreat by all investors from securities issued by financial institutions. Charges that money market funds caused those markets to freeze are a startling mischaracterization of the crisis.

**Question 6**

The SEC proposal does not require money market funds to hold capital. But aren't money market funds just shadow banks—they engage in maturity and liquidity transformation? A case can be made that money market funds act like banks but do not have the same kinds of protections as banks such as capital, access to the Fed's discount window, deposit insurance and so forth. Doesn't this suggest that the SEC require money market funds to hold capital?

**ICI Answer**

The terms "shadow banks" and "shadow banking" generally have been used to refer to credit intermediation involving leverage and maturity transformation outside of the traditional banking system. Describing money market funds as "shadow banks," however, simply does not accurately reflect their activities or operations and incorrectly equates money market fund shares and bank deposits. Money market funds are not banks. Unlike banks, money market funds do not make loans or use other forms of debt financing, do not use leverage, and generally are much more highly restricted than banks in the kinds of assets they may hold.

Furthermore, the term "shadow" inappropriately suggests that money market funds lack transparency or are unregulated. This is not the case for money market funds. Indeed, the very term "shadow bank" implies that any credit intermediation that involves

entities and activities outside the traditional banking system is inherently inappropriate and therefore best eliminated or subsumed within the banking system. We find this view particularly inappropriate given the perennial banking crises that occur despite numerous global efforts to increase bank capital and reduce risk.

Non-bank financial intermediaries, such as money market funds, play a variety of important roles in the financial system. These roles may share some similarities with the role that banks play—but there are also critical differences and those differences should be respected. In our judgment, simply evaluating the regulation of what clearly are capital market activities solely through a banking lens distorts and ignores the very substantive regulation and oversight to which these entities are subject through the securities laws. Rather, banks and capital markets have existed alongside one another in the United States for centuries, with parallel bodies of regulation and oversight that have arisen to address specific financial and investor risks associated with each type of credit intermediation. The U.S. financial system and our economy at large have thrived on the benefits that banks and capital markets provide.[5]

In truth, money market funds are stringently regulated by the Securities and Exchange Commission. As mutual funds, they are governed by substantive provisions that not only protect shareholders, but also guard against systemic risk. Mutual funds are regulated under all four of the major U.S. securities laws: the Securities Act of 1933, which requires registration of the mutual fund's shares and the delivery of a prospectus; the Securities Exchange Act of 1934, which regulates the trading, purchase and sale of fund shares and establishes antifraud standards governing such trading; the Investment Advisers Act of 1940, which regulates the conduct of fund investment advisers and requires advisers to mutual funds to register with the SEC; and, most importantly, the Investment Company Act of 1940, which requires all mutual funds to register with the SEC and to meet significant operating standards.[6] Thus, the extensive regulatory framework applicable to mutual funds, although different from bank regulation, is stringent and robust.

Unlike other mutual funds, money market funds also must comply with an additional set of regulatory requirements under Rule 2a-7 under the Investment Company Act that are designed to limit the fund's exposure to certain risks governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments. Indeed, these requirements have always ensured that the degree of liquidity, maturity, and credit transformation of money market funds is modest. The 2010 amendments to

[5] For a history of the successful co-existence of the U.S. banking and securities industries, *see* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Secretariat of the Financial Stability Board (June 3, 2011) at Appendix A.

[6] Mutual funds are also subject to oversight by state securities commissions and self-regulatory organizations, such as the Financial Industry Regulatory Association ("FINRA"). FINRA is a self-regulatory organization that oversees broker-dealers that distribute mutual fund shares and mutual fund advertising.

SEC rules governing money market funds have made such transformation even more modest. Today's money market funds are stronger and more resilient than the funds that were available in 2008. The 2010 amendments directly and meaningfully addressed this "transformative" concern through, among other things, new liquidity requirements and new maturity limits. (*See* ICI answer to question from Congresswoman Terri Sewell below)

The active oversight of money market funds by the SEC clearly demonstrates that they are not vehicles without regulatory attention. Indeed, imposing bank-like regulatory requirements, such as capital, on money market funds would alter fundamentally the money market fund business model. A money market fund, like every other mutual fund, provides investors a pro rata interest in the fund, whereby fund investors share in the risk and rewards of the securities held by the fund. All of the fund's shares are equity capital. Although the default risk of the highly diversified, short-term portfolios held by money market funds is low, it is shared equally by all fund investors. Imposing capital requirements on a fund adviser, for example, would transform the essential nature of a money market fund by interposing the adviser between the fund and its investors. Requiring all fund advisers to take a first-loss position would be a radical departure from the current agency role that fund advisers play. The mutual fund structure, including that of money market funds, is designed so fund advisory fees compensate the adviser for managing the fund as a fiduciary and agency and for providing ongoing services that the fund needs to operate. Advisers are not compensated for bearing investment risks of the fund.

Shifting investment risks from fund investors to advisers would require advisers to dedicate capital to absorb possible losses of the funds that they manage. Some advisers would have to raise new capital in the market. Others could perhaps shift capital from other parts of their businesses. Either way, all advisers would have to earn a market rate of return on such capital. If they cannot earn that rate of return, they would find better business alternatives, such as seeking to move investors to less-regulated cash management products where investors still must bear the risks of investing. This would do little to reduce systemic risk but instead would reduce choice and competition. The consequences would include significant disruptions in a crucial source of short-term funding for businesses, colleges and universities, nonprofit organizations, government agencies, and financial institutions, as well as redirected investor money to less regulated, opaque cash pools.

**Question 7**

Money market funds asked for and received a guarantee from the federal government after Lehman Brothers failed. Doesn't that suggest that money market fund investors now believe that the federal government implicitly guarantees money market funds? In a future crisis, what's to prevent money market funds from again asking for and receiving a

government guarantee? Does the Dodd-Frank Act specifically prohibit the federal government from providing any kind of guarantee for money market funds?

**ICI Answer**

During September 2008, the financial crisis reached a critical stage, characterized by severely reduced liquidity in the global credit markets and insolvency threats to investment banks and other institutions. In response, the Federal Reserve announced a series of programs and facilities designed to stabilize the market, which had ceased to function even for very short-term, high-credit securities. The Treasury also announced its Temporary Guarantee Program for Money Market Funds ("TGP"), which temporarily guaranteed existing account balances in money market funds that qualified for and elected to participate in the Program. The TGP was backed by Treasury's Exchange Stabilization Fund.

ICI did not ask for this, or for any other federal guarantee. ICI did, however, play a significant role in limiting the reach of the TGP. It urged from the outset that the guarantee not be open-ended, as Treasury originally contemplated, but instead restricted to account balances as of September 19—the date of the program's original announcement. ICI was concerned that markets would be further disrupted under the TGP by significant flows of money into guaranteed prime money market funds from banks, Treasury funds, and other cash-like products. Massive dollar flows in the other direction could create yet another wave of volatility when the TGP ended. The TGP expired on September 18, 2009, without receiving a single claim. Instead, Treasury—and, as a result, taxpayers—received an estimated $1.2 billion in fees paid by participating money market funds.[7] Other than the one year TGP, money market funds have never been insured or guaranteed by the FDIC or any other government agency. No such guarantee is in place today.

Congress erected barriers to future guarantees or support programs for money market funds. In the Emergency Stabilization Act of 2008, Congress barred the Treasury from using its Exchange Stabilization Fund "for the establishment of any future guaranty programs for the United States money market mutual fund industry." In addition, in the Dodd-Frank Act, Congress limited the Federal Reserve's ability to establish the types of programs and facilities it used to stabilize the market in 2008. As a result, Congress has erected significant barriers against the renewal of any sort of guarantee or support program for money market funds.

**Question 8**

It was suggested at the hearing that money market funds suffered runs during the 2007-2008 financial crisis, but banks did not have deposit runs. Is this correct?

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[7] *See* http://www.treasury.gov/press-center/press-releases/Pages/tg293.aspx.

**ICI Answer**

No, this is not correct. Certain banks did suffer deposit runs. Two prominent examples include: IndyMac Bank[8] and Washington Mutual Bank.[9] Many more banks failed and were closed by the FDIC.[10]

**Question 9**

It was suggested at the hearing by Sheila Bair that industry asked for the Money Market Fund Guarantee program [to be] put in place by the Department of Treasury in 2008. Can you please elaborate about the industry's role in the MMF guarantee program and its costs to taxpayers?

**ICI Answer**

As noted above in our answer to Question 7, the money market fund industry did not ask for the TGP or any other form of support during the financial crisis. In fact, ICI worked with Treasury and other regulators to limit the reach of the TGP, urging that the guarantee be limited and temporary.

**Question from Congresswoman Terri Sewell (AL-07)**

The SEC implemented reforms to money market mutual funds in May 2010. Could you please explain some of the changes made to money market mutual funds at that time and the effects these changes have had on investors and the funds themselves?

**ICI Answer**

The SEC's 2010 amendments to money market fund regulation have made these funds even more stable, liquid, and transparent than ever before.

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[8] For discussions concerning IndyMac Bank, *see e.g.*,
http://www.paulhastings.com/Resources/Upload/Publications/947.pdf;
http://www.americanbanker.com/issues/173_140/-358143-1.html;
http://www.npr.org/templates/story/story.php?storyId=92578023; and
http://www.youtube.com/watch?v=2EnaU7D80oM.

[9] For discussions concerning Washington Mutual Bank, *see e.g.*, U.S. Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (January 2011), available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf, at 365 ("In the eight days after Lehman's bankruptcy, depositors pulled $16.7 billion out of Washington Mutual, which now faced imminent collapse."); http://www.calculatedriskblog.com/2009/10/report-wamu-bank-run-rumors-were-true.html.

[10] *See* http://www.fdic.gov/bank/individual/failed/banklist.html; *see also generally*, Your Bank Has Failed: What Happens Next?, *60 Minutes*, CBS (March 8, 2009), available at http://www.cbsnews.com/news/your-bank-has-failed-what-happens-next/ (includes interview with FDIC Chairman Sheila Bair).

*Liquidity*

The 2010 amendments directly and meaningfully addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit minimum daily and weekly liquidity requirements. Under the new requirements, money market funds must maintain a sufficient degree of portfolio liquidity to meet reasonably foreseeable redemption requests. In addition, all taxable money market funds are required to hold at least 10 percent of their portfolios in assets that can be turned into cash within a day, and all funds must hold at least 30 percent in assets that are liquid within a week. The amendments also require funds, as part of their overall liquidity management responsibilities, to have "know your investor" procedures to help fund advisers anticipate the potential for heavy redemptions and adjust their funds' liquidity accordingly, and to have procedures for periodic stress testing of their funds' ability to maintain a stable NAV. Indeed, the SEC staff found that the new liquidity requirements have made money market funds "more resilient to both portfolio losses and investor redemptions."[11]

In practice, prime money market funds have exceeded the liquidity minimums by a significant margin, and now hold twice as much in weekly liquid assets as the heaviest redemptions they faced in the worst week of the financial crisis in September 2008. Indeed, the ongoing fragility of the markets since the 2007–2008 crisis—attributable to a variety of factors, including regulatory uncertainty, the U.S. federal debt ceiling crisis in mid-2011 and 2013, and conditions in European debt markets—has prompted many money market fund managers to hold larger amounts of liquidity as a way to mitigate risks.

Moreover, the liquid assets that now make up much of prime money market funds' portfolios are overnight repurchase agreements and Treasury and other government securities—exactly the types of securities that anxious investors want to buy in a crisis and the types of assets that government money market funds hold. For every dollar that flowed out of prime money market funds in September 2008, 61 cents went back into Treasury and government money market funds. In a future crisis, to match investors' shifting demands, government money market funds and other investors would be ready buyers of many of the liquid assets that prime funds wish to sell. This is in sharp contrast to 2008, when prime money market funds held far fewer Treasury and agency securities and sought to sell commercial paper and similar assets that did not have a ready market in the wake of a wave of financial institution failures.

In fact, many of the asset classes that make up prime money market fund portfolios today constitute "high-quality liquid assets" for purposes of the Basel III Liquidity Coverage Ratio ("LCR"). According to the Basel Committee on Banking

[11] *See* SEC Staff Study at 37.

Supervision, LCR-eligible assets have the following liquidity-related characteristics: (i) they are traded in active and sizeable markets; (ii) they have committed market makers; (iii) they have low market concentration; and (iv) they are "flight to quality" assets, *i.e.*, "historically, the market has shown tendencies *to move into these types of assets* in a systemic crisis."[12] In fact, the Basel Committee has proposed that internationally active banks be *required* to hold the *same assets* that money market funds hold to protect against illiquidity. Indeed, the overnight repurchase agreements and Treasury and other government securities that now make up much of prime money market funds' portfolios are precisely the asset classes favored by the LCR framework.[13]

*Maturity*

In addition to the new liquidity requirements, the 2010 amendments require that a money market fund's weighted average maturity ("WAM") and weighted average life ("WAL") cannot exceed 60 and 120 days, respectively.[14] The SEC Staff Report found that the new maturity limits have "improved the resiliency of money market funds to interest rate shocks."[15] These requirements reduce liquidity and maturity transformation to very low levels.

*Increased Disclosure*

By requiring more frequent and vastly more detailed disclosure of money market funds' holdings, the 2010 amendments have made money market funds one of the most transparent financial products in the United States. On a monthly basis, these funds now must disclose every security they hold, every piece of collateral backing repurchase agreements, as well as other salient information, including their mark-to-market NAV. Many funds voluntarily are providing more portfolio holdings and mark-to-market value disclosure than what is required. Regulators, analysts, and investors have been using this additional data to closely scrutinize fund portfolios. This heightened scrutiny has at times led regulators and analysts to highlight potential risks in particular fund holdings. The additional disclosure also has led certain advisers to avoid investments that, although exhibiting stable credit fundamentals, may raise investor concerns. Thus, the discipline

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[12] *See* Basel Committee on Banking Supervision, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* 5 (December 2010), available at http://www.bis.org/publ/bcbs188.pdf.

[13] *Id.* at 8 (permitting banking organizations to hold unlimited amounts of "Level 1" assets for purposes of the LCR, which includes claims on or claims guaranteed by sovereigns).

[14] The introduction of a limit on money market funds' WAL has strengthened the ability of money market funds to withstand shocks and meet redemption pressures. Unlike a fund's WAM, a portfolio's WAL is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer-term adjustable-rate securities that may expose a fund to credit risk.

[15] *See* SEC Staff Study at 30.

of far greater disclosure, consistent with the SEC's historical approach to protecting investors, in itself has had a strong palliative effect.

*Board Powers*

The 2010 amendments also created a powerful new tool for money market fund boards of directors. If a money market fund cannot meet redemptions without breaking the dollar, the 2010 amendments, through new Rule 22e-3 under the Investment Company Act, allow the fund's board to liquidate the fund in an orderly manner—without a fire sale of portfolio securities or a first-mover advantage for early redeemers.[16] In September 2008, the Reserve Primary Fund's board did not have the ability to promptly suspend redemptions—leading to a chaotic response when the fund broke the dollar. Now, the SEC has given money market fund boards a mechanism that will, in the SEC's own words, allow for the "orderly liquidation of fund assets" for a troubled fund and "reduce the vulnerability of investors to the harmful effects of a run on the fund, and minimize the potential for disruption to the securities markets."[17]

To use this power, a board must decide to liquidate the fund. By suspending redemptions, the board helps protect all shareholders and ensures that "sophisticated" investors can't exit first and inflict losses on those remaining behind. The new rule recognizes that a money market fund's share price can decline in value, and provides for an orderly liquidation of the fund's securities in a manner that best serves all of the fund's shareholders.

[16] The board continues to have the option to instead reprice the fund's shares and allow the fund to remain open but with a floating NAV.

[17] *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 FR 10060 (March 4, 2010) at 10088.